



3-1-1971

Criminal Liability of Public Accountants: A Study of United States v. Simon

Fred Kuhar

Follow this and additional works at: <http://scholarship.law.nd.edu/ndlr>



Part of the [Law Commons](#)

Recommended Citation

Fred Kuhar, *Criminal Liability of Public Accountants: A Study of United States v. Simon*, 46 Notre Dame L. Rev. 564 (1971).

Available at: <http://scholarship.law.nd.edu/ndlr/vol46/iss3/7>

This Note is brought to you for free and open access by NDLScholarship. It has been accepted for inclusion in Notre Dame Law Review by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.

THE CRIMINAL LIABILITY OF PUBLIC ACCOUNTANTS: A STUDY OF UNITED STATES v. SIMON

I. Factual Background

On November 12, 1969, the United States Court of Appeals for the Second Circuit affirmed the convictions of Carl J. Simon, Robert H. Kaiser, and Melvin S. Fishman, three members of Lybrand, Ross Bros. & Montgomery, one of the leading international public accounting firms.¹ The convictions had been rendered on three counts of an indictment charging the men with drawing up and certifying a false and misleading financial statement (the balance sheet) of Continental Vending Machine Corporation as of September 30, 1962, and with mailing the same, thereby conspiring to violate 18 U.S.C. §§ 1001² and 1341³ and § 32 of the Securities and Exchange Act of 1934.⁴

1 United States v. Simon, 425 F.2d 796 (1969). On March 31, 1970, the Supreme Court denied *certiorari* in this case indicating that there had been sufficient evidence produced at the trial to warrant submission to the jury. *Simon v. United States*, 397 U.S. 1006 (1970).

2 18 U.S.C. § 1001 (1964) provides:

Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined not more than \$10,000 or imprisoned not more than five years, or both.

3 18 U.S.C. § 1341 (1964) provides:

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting to do so, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Post Office Department, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than \$1000 or imprisoned not more than five years, or both.

4 § 32 of the Securities and Exchange Act of 1934 provides:

(a) Any person who willfully violates any provision of this chapter, or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than \$10,000, or imprisoned not more than two years, or both, except that when such person is an exchange, a fine not exceeding \$500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

(b) Any issuer which fails to file information, documents, or reports required to be filed under subsection (d) of section 78o of this title or any rule or regulation thereunder shall forfeit to the United States the sum of \$100 for each and every day such failure to file shall continue. Such forfeiture, which shall be in lieu of any criminal penalty for such failure to file which might be deemed to arise under subsection (a) of this section, shall be payable into the Treasury of the United States and shall be recoverable in a civil suit in the name of the United States.

(c) The provisions of this section shall not apply in the case of any violation of any rule or regulation prescribed pursuant to paragraph (3) of subsection (c) of section 78o of this title, except a violation which consists of making, or causing to

The three had been indicted in October of 1966 and brought to trial in December, 1967. Although the defendants had waived a jury trial, the Government would not consent to such waiver, thereby requiring the trial court to deny the defense motion that the case be tried without a jury.

After a nine-week trial, the jury stood deadlocked at eleven to one for acquittal on the conspiracy count and eight to four for acquittal on the mail fraud counts. A second trial, commencing in May of 1968—again before a jury and again over defendants' objection—culminated in the guilty verdict on June 21, 1968.⁵

be made, any statement in any report or document required to be filed under any such rule or regulation, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact. 15 U.S.C. § 78 ff. (1964).

5 The extent to which the accounting profession can be subjected to civil liability is rather well settled at present. There is authoritative case law defining the accountant's duties of reasonable care to his client. *See, e.g.,* Gammel v. Ernst & Ernst, 245 Minn. 249, 79 N.W.2d 364 (1955); Ultramares Corporation v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931). *See also* Cafritz v. Corporation Audit Co., 60 F. Supp. 627 (D.D.C. 1945); Maryland Casualty Co. v. Cook, 35 F. Supp. 160 (E.D. Mich. 1940); L.B. Laboratories v. Mitchell, 39 Cal. 2d 56, 224 P.2d 385 (1952); Dantzer Lumber & Export Co. v. Columbia Casualty Co., 115 Fla. 541, 156 So. 116 (1934); Board of Comm'rs v. Baker, 152 Kan. 164, 102 P.2d 1006 (1940); East Grand Forks v. Steele, 121 Minn. 296, 141 N.W. 181 (1913); National Surety Corp. v. Lybrand, 256 App. Div. 226, 9 N.Y.S.2d 554 (1939); Smith v. London Assur. Corp., 109 App. Div. 882, 96 N.Y.S. 820 (1905); Duro Sportswear, Inc. v. Cogen, 131 N.Y.S.2d 20 (Sup. Ct. 1954), *aff'd mem.*, 285 App. Div. 864, 137 N.Y.S.2d 829 (1955); State Street Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E.2d 416, *rehearing denied*, 278 N.Y. 704, 16 N.E.2d 851 (1938); Squyres v. Christian, 242 S.W.2d 786 (Tex. Civ. App. 1951). Several cases deny liability, but cite the same principles. *See, e.g.,* Flagg v. Seng, 16 Cal. App. 2d 545, 60 P.2d 1004 (1936); Fidelity & Deposit Co. v. Atherton, 47 N.M. 443, 144 P.2d 157 (1943); Craig v. Anyon, 212 App. Div. 55, 208 N.Y.S. 259 (1925), *aff'd mem.*, 242 N.Y. 569, 152 N.E. 431 (1926); O'Neil v. Atlas Automobile Finance Corp., 139 Pa. Super. 346, 11 A.2d 782 (1940); Atkins v. Crosland, 406 S.W.2d 263 (Tex. Civ. App. 1966).

There is also authoritative case law defining the accountant's duties to comply with the standards of the accounting profession. *See, e.g.,* Escott v. Barchris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). *See also* O'Connor v. Ludlam, 92 F.2d 50 (2d Cir. 1937), *cert. denied* 302 U.S. 758 (1937); Board of Comm'rs v. Baker, *supra*; Blank v. Kaitz, 350 Mass. 779, 216 N.E.2d 110 (1966); Gammel v. Ernst & Ernst, *supra*; National Surety Corporation v. Lybrand, *supra*; excerpts of address by Walter J. Coakley of Sullivan & Cromwell, New York, before the Ohio Society of Certified Public Accountants, in Cleveland, Oct. 19, 1967, in 126 J. ACCOUNTANCY 58, 60 (July, 1968) [hereinafter cited as 126 J. ACCOUNTANCY].

When a professional institution with the status of the American Institute of CPAs Accounting Principles Board issues a pronouncement, an accountant may well be held legally liable for failure to comply with it. The Appellate Division of New York in the *Bloch v. Klein* case judged the accountants' duty to check and report on inventory by a rule of the AICPA, stating that the rule "without any doubt, fixes the existing and accepted standards of their profession."

The accountant's duties to discover fraud are also well defined. *See, e.g.,* National Surety Corp. v. Lybrand, *supra*. *See also* Maryland Casualty Co. v. Cook, *supra*; Dantzer Lumber & Export Co. v. Columbia Casualty Co., *supra*; Board of Comm'rs v. Baker, *supra*; East Grand Forks v. Steele, *supra*; Smith v. London Assur. Corp., *supra*. For cases denying liability on the same principles, *see* Fidelity & Deposit Co. v. Atherton, *supra*; Craig v. Anyon, *supra*; O'Neil v. Atlas Automobile Finance Corp., *supra*; AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENT ON AUDITING PROCEDURE No. 33, AUDITING STANDARDS AND PROCEDURES 10-11 (1963) [hereinafter cited as STATEMENT 33].

The accountant's duties with respect to third parties are set out in *Ultramares Corporation v. Touche*, *supra*. *See also* Security-First National Bank v. Lutz, 297 F.2d 159 (9th Cir. 1961); C.I.T. Financial Corp. v. Glover, 224 F.2d 44 (2d Cir. 1955); O'Connor v. Ludlam, *supra*; Investment Corp. v. Buchman, 208 So.2d 291 (Fla. 1968); Blank v. Kaitz, *supra*; Fidelity & Deposit Co. v. Atherton, *supra*; Teich v. Arthur Andersen & Co., 40 Misc.2d 519, 243 N.Y.S.2d 368 (1963), *rev'd per curiam*, 24 App. Div. 2d 749, 263 N.Y.S.2d 932 (1965); Mutual Ventures, Inc. v. Baroness, 17 Misc.2d 483, 186 N.Y.S.2d 308 (1959); Duro Sportswear v. Cogen, *supra*; State Street Trust Co. v. Ernst, *supra*; Landell v. Lybrand, 264 Pa. 406, 107 A. 783 (1919); American Indemnity Co. v. Ernst & Ernst, 106 S.W.2d 763 (Tex. Civ. App. 1937); S. LEVY, ACCOUNTANTS' LEGAL RESPONSIBILITY (1954).

The defendants were two partners and an audit manager of Lybrand in charge of the fiscal 1962 audit of Continental. Harold Roth was president, chairman of the board, and the controlling stockholder of Continental. He was also an officer and major stockholder of Valley Commercial Corporation, a firm that, for all practical purposes, he managed and controlled from a single office on Continental's premises.

Valley Commercial Corporation was a finance company organized by Roth to finance various operations of Continental and other firms in the vending machine business. Valley's main sources of working capital included Continental itself and two commercial banks, Franklin National Bank and Meadowbrook National Bank. The "Valley Receivable," as it came to be known, representing Continental's advances to Valley, and its accounting treatment by the defendants are the center of controversy in this case.

During the period from January, 1958, to February, 1963, Continental

The limits of the accountant's duties are defined in *C.I.T. Financial Corp. v. Glover, supra*; *State Street Trust Co. v. Ernst, supra*; *Beardsley v. Ernst*, 47 Ohio App. 241, 191 N.E. 808 (1934).

Statutes today provide the most important source of liability for accountants. The most notable, of course, are the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. See, for example, 15 U.S.C. §§ 77k, 77x, 78j(b), and 78r (1964).

The need for statutory liability arises because of the vast changes that have overtaken the accounting profession since 1930. The rise of the large, publicly held corporation into national prominence and the fantastic volume of securities traded among parties who do not ever see or know one another have drastically changed both the role of the auditor and the very essence of the audit.

Financial statements, certified by an independent accountant [certification is required on statements of corporations having at least \$1 million in assets and 500 or more holders of a class of equity securities, Securities Exchange Act of 1934, 15 U.S.C. § 78m(a)(2) (1964)] serve to protect the public and prevent the manipulation of securities' prices via misrepresentations contained therein. Therefore, the accountant's duty to the public is substantial. See *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967) and *Touche, Niven, Bailey & Smart*, 37 S.E.C. 629, 670-71.

Of course, the principles of common law contract and tort liability applying to accountants are, in many instances, wholly inapplicable to present-day situations and leave injured parties without remedy. Justice Cardozo, however, in *Ultramares Corporation v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), prophetically pointed out that any change in the law to correct this state, "if expedient, must be wrought by legislation." *Id.* at 187, 174 N.E. at 447.

The standards of the profession have become much more stringent than those imposed at common law. The statutes, taking cognizance of the real life circumstances, can and do alter the common law by eliminating or adding, as needed, elements of various causes of action, and defenses and by shifting the various burdens of proof. In this way, a just and equitable, but also realistic, basis for liability has been created.

For two excellent analyses of the statutory liability presently imposed on accountants, see Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437, 1444-52 (1967) (this article could more aptly be titled "Various Ways to 'Get' Accountants and Recommendations That Will Implement the Popularity of the Sport") and Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139 (1968).

For an example of an extremely significant case decided recently under the Securities law, see *Escott v. Barchris Construction Corp.*, *supra*, where liability was predicated on the Securities Act of 1933, 15 U.S.C. § 77k (b) (1969) which defines the accountant's duty of due diligence. The provision, in pertinent part, reads:

Notwithstanding the provisions of subsection (a) of this section no person . . . shall be liable as provided therein who shall sustain the burden of proof—

(3) that . . . (B) as regards any part of the registration statement purporting to be made upon his authority as an expert . . . (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . .

Considering the recent "litigation explosion" in the accounting profession (as of November,

itself and two commercial banks. The "Valley Receivable," as it came to be regularly made advances to Valley and Valley periodically made repayments to Continental. During the same period, Valley loaned money to Roth to finance his ventures in the stock market. Prior to September 30, 1962, Roth regularly repaid Valley. The Valley Receivable was characteristically higher during the year than at year-end. Although Continental loaned Valley over \$17 million during the period in question, the year-end balances of the Valley Receivable for the years 1958 through 1962 were:

September 30, 1958	\$ —0—
1959	384,402
1960	397,996
1961	848,006
1962	3,543,335 ⁶

Valley's advances to Roth during this time amounted to approximately \$13 million of which about \$10 million was repaid.

Prior to the fiscal 1962 audit, Lybrand's procedures were somewhat routine with respect to the Valley Receivable. The balance was confirmed in writing and reconciled to the amount appearing on Continental's books; the computation of accrued interest was checked; Continental vouchers supporting disbursements to Valley were examined; and cancelled checks representing the advances to Valley were examined, noting that they were received by Valley and endorsed for deposit to Valley's account at the Franklin National Bank. For each year, the Valley Receivable was segregated in the financial statements, and after 1959 Roth's relationship to Valley was disclosed.

1966, it was reported that 50 to 100 lawsuits were pending against the "Big Eight" accounting firms. See Wall Street Journal, Nov. 15, 1966, at 1, col. 6, at 13 col. 2; see also Byrd, *Accountancy and the Onslaught of Case Law in North America*, 157 THE ACCOUNTANT 34 (1967) and Wise, *The Very Private World of Peat, Marwick, Mitchell*, FORTUNE, July, 1966, at 89-91). It might very well be that a whole new set of principles regarding accountants' liability will be formulated. This could very well presage the ultimate fall of *Ultramares* as the keystone of precedent on the accountants' liability to third parties. See Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, *supra* (appraisal of *Ultramares* status with commentary on its inadequacy with respect to protecting the interests of certain classes of third parties) and Note, *Accountants' Liabilities for False and Misleading Financial Statements*, *supra* (advocacy of any steps that will tend to implement any efforts by anybody to collect a judgment from a CPA firm).

But Walter J. Coakley has said:

In my judgment, the rules laid down in *Ultramares* still constitute, in this country, the law of accountants' liability to third persons. Except where changed by statute (such as under federal securities laws), courts have continued to refuse to find liability to third parties for ordinary negligence unless the third parties were identified to the accountant and he knew that a primary purpose of his report was to induce them to act in reliance on it. Of course, in cases of gross negligence or recklessness, the equities shift and the courts find ways to spread the liability among a larger group of third parties. . . . The problem has been how to establish a workable set of rules the courts can use in applying the principle to the broad spectrum of factual situations. . . . When you analyze the results reached on the facts of the various cases, however, it seems to me that the law today remains the law Judge Cardozo established in 1931 in *Ultramares*. (Footnote omitted.) 126 J. ACCOUNTANCY 58-59.

6 Balances of the receivable at interim dates help to illustrate the pattern: April, 1960—\$1,583,000; December 31, 1961—approximately \$2 million; December 31, 1962—approximately \$3.9 million.

With the substantial increase in the Valley Receivable at September 30, 1962, Simon determined that it would be necessary to examine Valley's audited financial statements (Lybrand did not audit Valley) in order to evaluate properly the collectibility of the receivable. Roth promised that Valley's statements would be made available as soon as they were ready. The statements, however, were never produced. When confronted by Simon on February 6, 1963, Roth admitted that Valley, although solvent, could not then pay the debt. He further stated that he personally was indebted to Valley in approximately the same amount.⁷ At this time, Roth offered to post his equity in certain marketable securities and a mortgage on his home and furnishings to secure Valley's debt to Continental. Simon agreed that if adequate collateral were posted, a satisfactory legal opinion obtained, and approval of the transactions given by Continental's board, there would be satisfactory evidence of the receivable's collectibility.

Initially, Roth's assignments of the collateral ran to Valley. Kaiser, however, felt that this measure did not adequately safeguard Continental's interests since Roth would be free to withdraw the money from Valley. At Kaiser's insistence, the assignments were made to run to Arthur Field, Continental's counsel, as trustee for Valley, to hold the securities for the benefit of Continental. In a letter to Lybrand dated February 14, 1963, Field outlined the collateralization procedures and stated that securities representing an equity of \$3.5 million (at market) were being posted as collateral on the loan. In the same letter, he rendered an opinion that the Continental loan to Valley was adequately secured.⁸

7 An issue at the trial and on appeal was exactly when the defendants learned of Roth's borrowings from Valley. There was evidence that various Lybrand personnel knew of the borrowings as early as 1958. Simon testified that he first learned of the situation in his conference with Roth on February 6, 1963. The question is of little importance, however, because it is an uncontested fact that all three defendants knew about Roth's borrowings when the statements were drawn up and the opinion rendered.

8 Excerpts from Field's letter are reproduced in the brief submitted by the appellant:

"As you know, Valley Commercial Corporation is presently indebted to Continental in the approximate net amount of \$2,900,000.00 (the net indebtedness as of the fiscal year end, September 30, 1962, being approximately \$2,500,000.00). Certain measures have been taken and are being taken to provide security by Valley for the repayment of its obligation to Continental and we are herewith setting forth the program which has been in progress and will be effectuated within one week from the date hereof:

"Harold Roth, Max Roth, David Roth, Robert Roth, Matthew J. Forbes and the Harrough Corp. have assigned to Valley securities consisting of stock of Continental, Hoffman International Corporation, Second Centennial Fund and bonds of Continental and Hoffman International Corporation in which they own an equity having a present market value equalling approximately \$3,500,000 over and above all liens.

"The assignments to Valley by the assignors are in the form of legal instruments which make the actual assignments to Arthur N. Field, as trustee for Valley.

"Arthur N. Field has executed his undertaking that he will receive either the cash equities in said securities, if they are sold by the present holders thereof, or the securities themselves if they are delivered to him as security for the repayment by Valley to Continental of the obligation due it. Any cash received by said Arthur N. Field will be immediately paid over to Continental in reduction of Valley's indebtedness. Any securities received by Arthur N. Field will be held by him solely as security for the indebtedness due from Valley to Continental and will be sold and disposed of by him in accordance with instructions received by him solely from Continental should Continental desire or require that such securities be sold in order to liquidate the balance of the indebtedness due from Valley to it.

"In addition to the securities which have an equity value of approximately \$3,500,000, as hereinbefore set forth, the said parties making the assignments are

On February 15th, James Harris, a supervisor at Lybrand, was given the task of verifying the existence of the assigned securities. At Kaiser's direction, Harris listened on an extension while Roth or his secretary called various banks and brokers holding the assigned securities. During each call the bank or broker was requested to describe the securities held and the amount of indebtedness against them. In addition, the bank or broker was requested to confirm this information in writing directly with Lybrand.⁹

Harris confirmed approximately \$3 million (equity value) of the securities in this manner and recorded the results on a work sheet. About 80% of the securities confirmed were stock and convertible debentures of *Continental*. Richard McDevitt, the Lybrand supervisor on the job, completed the worksheet by checking the market value and computing the equity over and above the reported liens for each of the listed securities.

The mortgage on Roth's home and furnishings (\$625,000) and loose stock certificates in Roth's office (\$100,000) were not included in Harris's worksheet. Certain other securities listed at a value of \$409,960 were not included because of their questionable value.

On the basis of the \$3 million in confirmed collateral, Roth's assurances that he would post additional collateral, the existence of the mortgage and other stock certificates, Field's representation that \$3.5 million was to be posted and his legal opinion as to the adequacy of the collateral, the defendants were satisfied that the Valley Receivable was collectible.

The note to the financial statements which explained the status of the Valley Receivable, segregated on the balance sheet as in previous years, read:

2. The amount receivable from Valley Commercial Corp. (an affiliated company of which Mr. Harold Roth is an officer, director and stockholder) bears interest at 12% a year. Such amount, less the balance of the notes payable to that company, is secured by the assignment to the Company of Valley's equity in certain marketable securities. As of February 15, 1963, the amount of such equity at current market quotations exceeded the net amount receivable.

also transferring and assigning to Valley additional securities so that Valley will be placed in a more solvent position. These additional securities will be retained by Valley subject to any and all claims and unpaid indebtedness due to Continental.

"As at the date of this letter, it is our opinion that the securities assigned secure the loan due from Valley to Continental." Brief for Appellant at 34-36, *United States v. Simon*, 425 F.2d 796 (1969) [hereinafter cited as Appellant's Brief].

9 A second important issue in the case involved the existence of undisclosed liens against the assigned securities amounting to approximately \$1.2 million. There were liens in this amount against securities held by Franklin National Bank, and James Talcott, Inc. securing borrowing by Continental, U.S. Hoffman Machine Corporation, and Valley which were not disclosed to Harris over the phone nor in Franklin's written confirmation to Lybrand (Talcott did not confirm in writing). Although there was evidence introduced (handwritten notes of Kaiser) that Simon and Kaiser had reason to know of or at least suspect these circumstances, neither gave Harris any indication that he should make specific inquiries of Franklin and Talcott regarding the liens. The Government contended that this was evidence of the defendants' intent to hide the true facts by shutting their eyes to inquiry where circumstances demanded such inquiry. If the defendants did not know of the liens, they should have known of them and should not be vindicated by their willing disregard of the facts plainly before them.

This issue weighed heavily in the jury's determination of guilt. While deliberating, the jury sent three questions to Judge Mansfield regarding these liens. While refusing to answer the questions directly, he summarized the evidence produced on the circumstances surrounding the liens. Prior to this colloquy, the jury had been deadlocked.

Also involved in the *Simon* case was a "Valley Payable." Continental had issued negotiable notes to Valley which had endorsed the notes in blank and discounted them at the Franklin and Meadowbrook banks, transferring the proceeds to Continental. Since the notes were negotiable, Continental could not offset the Valley Payable against the Valley Receivable.

Though Continental's balance sheet showed the payable separately from the receivable, the note indicated that the collateral secured the *net* receivable, or about \$2.5 million.¹⁰

The financial statements were "dismal by any standard."¹¹ Compared with an after-tax profit of \$1,249,000 in 1961, Continental reported an operating loss of \$867,000 and write-offs of another \$3 million in 1962. Ratios within the statements suffered in almost every category. The statements did not reflect the efforts of anyone trying to paint an unusually bright picture.

The mailing of the statements as part of Continental's annual report had quite an effect on the value of that part of the collateral consisting of Continental stock and debentures. By February 25th, the collateral was worth only \$395,000. Lybrand withdrew its opinion on the statements. When a Continental check to the Internal Revenue Service bounced, the plant was padlocked and the American Stock Exchange suspended trading in Continental's stock. Bankruptcy and an SEC investigation followed.

At the outset, eleven co-conspirators were named, but by the end of proceedings only Roth and the three Lybrand men remained implicated. Roth pleaded guilty to the conspiracy count and turned state's evidence along with three of his associates who had originally been among the eleven.¹²

The Government contended that the defendants conspired to cover up Roth's indirect borrowings from Continental and that they had a duty to disclose those borrowings on Continental's statements along with information regarding the post-balance sheet increase in the Receivable (to \$3.9 million), the makeup of the collateral, and the fact that the Valley Receivable and the Valley Payable could not be offset.

The Government drafted a "Footnote 2" to demonstrate what it considered adequate to have discharged the defendants' burden of disclosure:

2. The amount receivable from Valley Commercial Corp. (an affiliated

10 Defendants maintained that they knew that the amounts could not be netted and that the note was an error. They claim that they thought the confirmed securities (\$3 million) provided an adequate cushion over the net receivable and that Roth's home mortgage and additional securities bolstered this even more.

The Government, on the other hand, felt that the defendants could not possibly have made such a gross error in drafting a note about the receivable, an item that had received such a great deal of attention from all of them. The Government's contention was that this was yet another attempt by the defendants to hide the true facts.

This, as the other issues mentioned in notes 7 and 9, *supra*, will not be treated at any length in this Note since in any event the defendants were justified in relying upon collateral of at least \$3.7 million (\$3 million confirmed, the mortgage, and the loose stock certificates) which exceeded the gross amount of the Valley Receivable.

Admittedly, in the absence of the alleged cushion over the net amount of \$2.5 million, prudent auditing technique would have dictated further procedures with respect to the mortgage and stock certificates; but since these two items did not ultimately fail as collateral, the question is moot here.

11 *United States v. Simon*, 425 F.2d 796, 800 (2d Cir. 1969).

12 See note 70 *infra*.

company of which Mr. Harold Roth is an officer, director and stockholder), which bears interest at 12% a year, was uncollectible at September 30, 1962, since Valley had loaned approximately the same amount to Mr. Roth who was unable to pay. Since that date, Mr. Roth and others have pledged as security for the repayment of his obligation to Valley and its obligation to Continental (now \$3,900,000, against which Continental's liability to Valley cannot be offset) securities which, as of February 15, 1963, had a market value of \$2,978,000. Approximately 80% of such securities are stock and convertible debentures of the Company.

The Government also presented many more of its own ideas as to what specific obligations the defendants had on the audit and how these obligations were affected by generally accepted accounting principles and the pronouncements of the American Institute of Certified Public Accountants [AICPA].

The purpose of this Note is to discover the extent to which the court in the *Simon* case imposed new obligations upon the accounting profession and to crystallize the impact of the resulting implications.

II. The Role of the Independent Auditor

What responsibilities does the independent auditor take upon himself? What exactly does he say in his report? What does he warrant? These questions are easily answered with the benefit of hindsight. Unfortunately, the auditor is confronted with a prospective outlook and must make decisions with only his professional judgment and the standards of the profession as guides. Certain principles must therefore be formulated, and these must be considered at every step of an audit.

Initially, it is important for the auditor to be aware of his objectives on a given engagement in order that he may select audit procedures designed to attain those objectives. Broadly speaking, the objectives of the usual audit might be described as follows:

The auditor must be satisfied that the financial statements do or do not present fairly the financial position and results of operations of the client in conformity with generally accepted accounting principles. He must also be convinced that such principles have or have not been applied on a consistent basis. Subservient to these main objectives are more specific objectives in each area of the audit. With respect to assets, for example, the auditor must determine that:

- 1) the assets are in existence at the balance sheet date or represent expenditures which will benefit a future period;
- 2) the assets are properly stated in the accounts;
- 3) all significant assets are recorded;
- 4) the assets are or are not free of any pledge or lien; and
- 5) the assets are properly described and classified on the balance sheet.¹³

¹³ These concepts are found in the audit manuals of one of the leading international public accounting firms. Access to the manuals for purposes of this paper was granted with an accompanying request that the firm not be named or quoted directly.

According to an official pronouncement of the AICPA:

The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position and results of operations. The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion. In either case, he states whether his examination has been made in accordance with generally accepted auditing standards. These standards require him to state whether, in his opinion, the financial statements are presented in conformity with generally accepted principles of accounting and whether such principles have been consistently applied in the preparation of the financial statements of the current period in relation to those of the preceding period.¹⁴

In the eyes of the profession, the end product of an audit is the opinion. Any responsibilities to be imposed upon the accountant must be imposed on the basis of the opinion.¹⁵ By channeling practically all of the accountant's responsibility through his report, a determination of what the report states gives rise to the creation of a forum in which the accountant's performance can be measured.

With the adoption of a standard report,¹⁶ the AICPA has laid a foundation

¹⁴ STATEMENT 33 at 9.

¹⁵ The financial statements are the representations and, therefore, the responsibility of management:

Management has the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounts, for the safeguarding of assets, and for devising a system of internal control that will, among other things, help assure the production of proper financial statements. The transactions which should be reflected in the accounts and in the financial statements are matters within the direct knowledge and control of management. The auditor's knowledge of such transactions is limited to that acquired through his examination. Accordingly, the fairness of the representations made through financial statements is an implicit and integral part of management's responsibility. The independent auditor may make suggestions as to the form or content of financial statements or he may draft them in whole or in part, based on the management's accounts and records. However, his responsibility for the statements he has examined is confined to the expression of his opinion on them. The financial statements remain the representations of the management.

Id. at 9-10. See also American Institute of Certified Public Accountants, ACCOUNTING RESEARCH BULLETIN No. 43, RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS, 10(1953): "the accounts of a company are primarily the responsibility of management. The responsibility of the auditor is to express his opinion concerning the financial statements and to state clearly such explanations, amplifications, disagreement, or disapproval as he deems appropriate"; AICPA, APB ACCOUNTING PRINCIPLES, CURRENT TEXT, § 510.12 (1968). For a more detailed analysis of the varying degrees of responsibility borne by people associated with financial statements, see GRADY, ACCOUNTING RESEARCH STUDY No. 7, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES, 5-20 (1965).

This has also been the position of the SEC for many years:

The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon the accounting. *Interstate Hosiery Mills, Inc.* 4 S.E.C. 706, 721 (1939).

¹⁶ In October of 1948, the AICPA issued *Statement on Auditing Procedure No. 24, Revision in Short-Form Accountant's Report or Certificate*. The standard report with a "clean opinion" adopted in that pronouncement, still in effect today, reads as follows:

We have examined the balance sheet of X Company as of June 30, 19__ and the related statement(s) of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

upon which to build the standards of the profession. The accountant can thus make his decisions (e.g., whether to pursue an item) and gauge his work on the basis of what he will say in his report.

Correlatively, the standard language in accountants' reports has come to have at least a limited meaning in the business community.¹⁷ Deviations from such language immediately alert the educated reader that perhaps a different degree of responsibility has been assumed by the accountant and that this should be kept in mind in evaluating the statements.

When the issue of the accountant's responsibility is raised in a court of law, the representations in the report seem to be the logical starting point for inquiry. It would also seem that they provide an adequate base upon which to attach liability.

The literature of the profession has built around the language found in the standard accountant's report. The purpose has been to define as precisely as possible what is said in the report. The standards of the profession, as formulated, indicate the quality of the representations and describe the environment from which they come. This creates a setting in which expert testimony can be meaningful and directed toward specific questions regarding the accountant's performance. It can rightly be expected that accountants be familiar with the literature of the profession and aware of current developments. There is therefore no problem with using expert testimony to prove what the accountant's representations mean and with holding him to them.

If the accountant's responsibilities are, in fact, neatly packaged within his report, the question remains: What does the accountant say in his report? Initially, he indicates whether his examination was made in accordance with generally accepted auditing standards.¹⁸ This is perhaps the most demanding and comprehensive representation in the report. Compliance with generally accepted auditing standards contemplates many things, including the attainment of personal and professional qualifications, the utilization of the accepted procedures of the profession in a competent manner tempered by professional judgment, and

In our opinion, the accompanying balance sheet and statement(s) of income and retained earnings present fairly the financial position of X Company at June 30, 19—, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Compare this with the Lybrand report issued with the Continental financial statements. See note 25 *infra*.

The wording of the present report conforms to SEC requirements for auditors' certificates, see SEC Reg. S-X, Rule 2-02, 17 C.F.R. § 210.2-02 (1969).

In preparing his report, the accountant is bound by the four reporting standards included among generally accepted auditing standards. These standards are treated at length in STATEMENT 33 at 40-74. They refer generally to the language found in the report.

Presently the Committee on Auditing Procedure of the AICPA is considering a revision in the wording of the standard short-form report. See note 21 *infra*.

17 See STATEMENT 33 at 57 which reads:

Because of the weight which the independent auditor's opinion carries with the investing and lending public and the responsibilities he assumes in expressing it, reasonable uniformity in the manner of stating the opinion is important both to the auditor and to those who rely on his findings.

18 This conforms with SEC Rule 2-02(b). See SEC Reg. S-X Rule 2-02(b), 17 C.F.R. § 210.2-02(b) (1969) and STATEMENT 33 at 97.

Of course, a certificate indicating non-compliance with generally accepted auditing standards during the examination would be worthless and would immediately put the reader on notice of the fact.

the expression of an opinion on the financial statements or an indication of reasons why one cannot be expressed.¹⁹ Each standard binds the accountant to its particular requirements and implications. It must also be indicated in the report that the accountant has done what he felt was necessary in the circumstances.²⁰ This warrants that the judgment of a professional was employed in selecting the auditing procedures used. Additionally, the accountant must express (or disclaim with reasons) an opinion on the fair presentation²¹ within the financial statements. If he has complied with generally accepted auditing standards, the results of his examination will usually dictate what his opinion must be. An informed, expert opinion must consider all relevant factors. An expert witness would undoubtedly be competent to testify whether a given opinion could have been honestly expressed in light of a given set of known facts and circumstances. The report further states whether the financial statements are presented in conformity

19 STATEMENT 33 at 15-16 provides that:

The generally accepted auditing standards as approved and adopted by the membership of the American Institute of Certified Public Accountants are as follows:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

A codification of auditing standards became necessary with the requirement that a reference to compliance with generally accepted auditing standards be made in the report. See notes 16 and 18 *supra*; SEC Reg. S-X, Rule 2-02(b), 17 C.F.R. § 210.2-02(b) (1969); STATEMENT 33 at 97. Each standard is like the report itself in that the meaning of each is treated within the literature of the profession in some detail. See STATEMENT 33 at 18-74.

The second general standard also complies with an SEC requirement. See SEC Reg. S-X Rule 2-01(a) and (b), 17 C.F.R. §§ 210.2-01(a) and (b) (1969).

20 See SEC Reg. S-X, Rule 2-02(b)ii, 17 C.F.R. § 210.2-02(b)ii (1969).

21 See 17 C.F.R. § 210.2-02(c) i (1969).

The proposed revision of the language in the standard short-form accountant's report, see note 16 *supra*, is the result of dissatisfaction with the rather nebulous phrase "present fairly." A clarification will possibly increase the degree of responsibility an accountant assumes, but it will also tend to bring the accountant's position more clearly into focus.

with generally accepted accounting principles.²² Again, this presupposes a knowledge of accounting principles on the part of the accountant. This representation can also be tested by expert testimony. Finally, the report indicates whether the accounting principles were applied consistently with respect to the current and preceding period in order that the reader may have a proper basis for comparison.²³

It cannot be said that the accountant's report does not afford an injured party an opportunity to challenge the accountant's performance. The accounting profession has not tried to insulate itself from responsibility with a set of self-serving statements. Rather, it has attempted to give the accountant something upon which to hang his hat. When he is out in the field, he needs some standard to meet. The literature of the profession is the only practical vehicle to set the standard. If this is inadequate, it is still the best available. It must be utilized to the fullest, continually being improved upon, until something better comes along.

Through the clarification of its objectives, the documentation of the gravamen of its representations, and the development of profession-wide standards and ethics, the accounting profession has sought to define clearly the accountant's obligations to the client, to the public, and to the profession while giving him at least half a chance to meet them in his everyday work.

Through the years, the SEC has worked hand-in-hand with the AICPA to achieve this goal and has demonstrated a willingness to understand and accept the profession's solutions to the problems.²⁴ Now the courts must be convinced.

III. Lybrand's Performance on the Continental Audit: Compliance with Generally Accepted Auditing Standards²⁵

A. Sufficient Evidence

One of the generally accepted auditing standards (referred to in the accounting profession as the Third Standard of Field Work) is: "Sufficient com-

22 This representation is one that has been a source of controversy because of the existence of alternative principles that enjoy general acceptance. The profession has been open to severe criticism, both from within and without, because of this situation.

The accounting principles employed by Lybrand were not at issue in this case, however.

For an interesting analysis of the problem, see Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 139-51, 195-99 (1968). See also ARTHUR ANDERSEN & CO., *ESTABLISHING ACCOUNTING PRINCIPLES—A CRISIS IN DECISION MAKING* (1965); SPACEK, *CORPORATE PROFITS: ACCOUNTING VARIATIONS AND THEIR EFFECT ON CORPORATE PROFITS* (1965).

23 See SEC Reg. S-X, Rules 2-02(c)(2) and 3-07, 17 C.F.R. §§ 210.2-02(c)(2) and 210.3-07 (1969).

24 Though the SEC has broad power to prescribe standards and principles that accountants must meet, the Commission has let most of it lie dormant, preferring to let the profession, through the AICPA, develop this area.

The authoritative pronouncements of the SEC consist of SEC Reg. S-X, 17 C.F.R. § 210 (1969), governing the form and content of financial statements filed with the Commission, and the *Accounting Series Releases*. Some of these prescribe accounting principles while others are reprints of quasi-judicial decisions of the Commission. In general, however, the Commission has seen fit to leave the philosophy of accounting to the profession. In turn, the profession has remained cognizant of the Commission's requirements and desires in the formulation of accounting principles.

25 For purposes of this discussion, it will be convenient to view the responsibilities imposed

petent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination."²⁶ The auditor's objective in the examination of a receivable is to establish the substantial accuracy of the amount, its validity as a claim against the recorded debtor and its collectibility.²⁷ In *Simon*, Lybrand virtually achieved this objective. There was no question as to the amount that Valley owed Continental at the balance sheet date. The receivable was confirmed; Valley acknowledged the debt. The only real question was collectibility. As to this, Lybrand found that Valley was unable to pay the debt because of Roth's corresponding uncollectible debt. The debt was therefore determined to be uncollectible.

If the receivable was to be properly included in Continental's balance sheet, however, it had to be collectible or fully reserved against. The posting of collateral is certainly a proper method of securing a debt and rendering it "collectible." In this case, to justify the implicit representation as to collectibility, Lybrand had to satisfy itself that the collateral was at least equivalent in value to a "collectible" Valley Receivable. The collateral, thus, had to be approached as though it were another of Continental's assets.

Since the collateral consisted of marketable securities,²⁸ Lybrand's objectives generally were those associated with the examination of investments. The auditor's objective in the examination of investments is to satisfy himself that

by the accounting profession (discussed in Section II of this Note, *supra*) as absolutely binding upon the defendants. This is necessarily the minimum standard. It could very well be that others (e.g., society, the courts, writers, the SEC) expect, and can, in some cases, enforce a higher standard, but there is no doubt as to the obligatory nature of the former. Duties beyond this will be treated at a later point.

In Lybrand's report (below) the only deviation from the standard language was a reference to departure from the consistency standard, not at issue in this case. For the purposes of this Note, Lybrand issued an unqualified opinion in its report on the Continental statements; only the standards and procedures relating to the Valley Receivable are at issue.

Lybrand's report read:

ACCOUNTANTS' OPINION

To the Board of Directors

Continental Vending Machine Corp.:

We have examined the consolidated balance sheet of Continental Vending Machine Corp. and its subsidiaries as of September 30, 1962 and the related consolidated statement of income (loss) and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying consolidated financial statements present fairly the consolidated financial position of Continental Vending Machine Corp. and its subsidiaries at September 30, 1962 and the consolidated results of their operations for the year then ended, in conformity with generally accepted accounting principles, which, except for the changes described in Note 5 relating to research and development expenses, development expenses in connection with the in-plant feeding program, and amortization of excess of cost of companies or operating properties acquired over related net assets, with which changes we concur, have been applied on a basis consistent with that of the preceding year.

/s/ Lybrand, Ross Bros. & Montgomery
Lybrand, Ross Bros. & Montgomery

New York, February 15, 1963.

26 STATEMENTS 33 at 16.

27 See note 13 *supra*.

28 The Continental shares owned by Roth were technically not marketable because they were not registered under the Securities Act of 1933. A charge that the defendants sought to conceal this fact in the financial statements was dismissed at the close of the Government's case.

securities owned are in the client's possession or that they are held by others for the account of the client and that the basis at which securities or other investments are carried in the accounts conforms with generally accepted accounting principles.²⁹

Here is where Lybrand's duty to obtain sufficient competent evidential matter came into full bloom. Audit procedures generally considered normal or standard in the examination of marketable securities include:

- 1) Obtaining a list of securities owned at the balance sheet date which sets forth details substantially as follows:
 - a) The exact name of the issuer and a description of the security.
 - b) The certificate number or bond number. (This may be omitted if securities are numerous and well controlled.)
 - c) The number of shares or total principal amount.
 - d) Cost (or carrying amount, if other than cost).
 - e) Market price per unit (citing the source and basis).
 - f) Total market price.
 - g) The location of the securities and, if hypothecated, with whom and for what purpose.
- 2) Accounting for the securities by:
 - a) Inspecting the securities on hand in the presence of the client's representative.
 - b) Obtaining confirmations of securities held by others as of the balance sheet date and as of the date of the inspection of securities on hand.
 - c) Confirming that the stock certificates and registered bonds are made out in the name of the client or that they are so endorsed as to be transferable to the client or are accompanied by powers of attorney.
- 3) Determining the basis or carrying amounts of the securities.
- 4) Checking market prices indicating the source and basis, such as last sales price or bid price.
- 5) Determining whether an allowance for losses on securities is required.³⁰

The information in the record as to the content of the workpapers and the information requested with the oral and written confirmations leads to the conclusion that Lybrand performed many of these audit procedures as well as others. While these might have been sufficient with an ordinary engagement, here they seem haphazard, careless, and inadequate.

The determination of Continental's (as opposed to Roth's, Valley's, and others') interest in the assigned securities was of vital importance. Despite at least a warning³¹ that there might have been prior liens against the securities, the

²⁹ See note 13 *supra*.

³⁰ *Id.*

³¹ See note 9 *supra*.

defendants did not alert Harris as to this circumstance, nor did they direct him to make any detailed inquiries regarding these securities.

Eighteen of the twenty-three banks and brokers confirmed in writing their oral conversations with Harris. This could, in some instances, be viewed as an acceptable level of response. But second requests were not sent out on the missing five,³² one of whom was Talcott.³³ In this case 100% response would certainly have been desirable, if not required.

Assurances were given by Roth that additional security would be posted. Field represented in his letter that \$3.5 million in collateral was being posted and that the collateralization would be completed by February 21, 1963.³⁴ His legal opinion indicated that the loan due from Valley to Continental was adequately secured. Such evidence normally has a measure of probative value. But could Roth and Field be taken at their word? Additional collateral was available.³⁵ Did the circumstances justify not including this collateral in the defendants' list and not performing audit procedures thereon?

Lybrand's greatest shortcoming was in the selection of procedures to determine the value of the securities. When a security is regularly traded over a period of time on a national exchange, a market quotation generally provides ample and reliable evidence of its value.³⁶ The question that must be asked, however, is whether the market quotations were *competent* evidence of the collateral's value in light of the circumstances.

According to the AICPA, the sufficiency and competency of evidential matter are measured in terms of affording the auditor a reasonable basis upon which to support his opinion. It must be the type of evidence that "permits him to reach conclusions through valid reasoning."³⁷

The amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his professional judgment *after a careful study of the circumstances in the particular case*.³⁸ (Emphasis added.)

The auditor must also consider the nature of an item, its materiality, and the possibility of errors or other irregularities in evaluating evidential matter.

The reasoning in this regard was faulty. With the collateral consisting in large part of Continental stocks and bonds, it is extremely doubtful that market quotations could have given a reliable indication of the securities' value.

32 From the facts enumerated in the appellant's brief, it appears that second requests were not sent out. The lack of time between Harris' phone confirmations and certification also warrants this conclusion. Appellant's Brief at 33-38.

33 See note 9 *supra*.

34 See excerpts of Field's letter reproduced at note 8 *supra*.

35 See note 10 *supra*.

36 It should be noted that valuation of securities in the accounts based upon market quotations higher than cost is not, except in rare instances, permissible under generally accepted accounting principles. Disclosure of market value in the statements, though, is an accepted and desirable practice.

It must be remembered, however, that in this instance the basis of valuation in the accounts was not in question. That was already determined (i.e., the value of the receivable). What was sought was evidence that the collateral was at least equivalent to this value. The market quotes supplied this evidence.

37 STATEMENT 33 at 35.

38 *Id.* at 36.

As the AICPA has warned: "The validity of evidential matter is so dependent on the circumstances under which it is obtained that generalizations about the reliability of various types of evidence are subject to important exceptions."³⁹ This case is a perfect example. Certainly, men with the defendants' knowledge and experience should have realized that the collateral's value was dependent upon Continental's financial position—a position that was in jeopardy. Certainly, they should have realized that the evidence they had was not sufficient basis for their opinion.

The decision to pursue additional evidence or evidence of a higher quality must be made in light of the degree of risk involved and the susceptibility of the item to conversion, manipulation, or misstatement. Evidence must be persuasive, not convincing. But if there is substantial doubt, an opinion cannot be rendered until additional evidence allays that doubt. Though the cost and time required to acquire audit evidence must be weighed against its value in the expression of an opinion, these factors do not by themselves justify not obtaining such evidence when it is necessary to the expression of an opinion.

In the *Simon* case, cost was not a factor (Lybrand was never paid for the Continental audit and the defendants could not have been unaware of the slim chances of collecting the fee at that time). Furthermore, the importance of the item surely outweighed the inconvenience and delay that would have attended acquiring enough information to properly evaluate the collateral.

Care should be used to not represent a receivable as *secured* unless it is known that the *realizable* value of the collateral is at least equal to the amount of the receivable.⁴⁰ Evaluating the evidential matter that the defendants had, it did not pass muster. The defendants did not give adequate consideration to a determination of the need to establish an allowance for losses on the securities. They did not evaluate the competency of the evidence which their procedures produced. They were simply too ready to accept the available evidence as indicative of the collateral's value.

B. Adequate Disclosure

Another significant departure from generally accepted auditing standards arises with the consideration of the following generally accepted auditing standard (referred to in the accounting profession as the Third Standard of Reporting): "Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."⁴¹

Although the Government did not make an issue of the defendants' compliance with generally accepted auditing standards,⁴² a substantial portion of its case was based upon the failure of the defendants to disclose certain information

³⁹ *Id.* at 35-36.

⁴⁰ See note 13 *supra*. Lybrand had a similar warning in its manuals, see 425 F.2d at 807, n. 9.

⁴¹ STATEMENT 33 at 16.

⁴² This is one of the major criticisms of the case. The Government treated the standards of the accounting profession as irrelevant at the trial, and jury instructions that condoned this attitude were critical issues on appeal. See text accompanying notes 114-28 *infra*.

it deemed essential to a fair presentation of Continental's financial position. According to the Government, the defendants had a duty to disclose:

- 1) that the receivable was uncollectible from Valley at the balance sheet date,
- 2) that Valley had loaned approximately the same amount to Roth who was also unable to pay,
- 3) the post-balance sheet rise in the receivable, and
- 4) the makeup of the collateral.⁴³

Absent such disclosure, it contended that Continental's balance sheet was fraudulently misleading.

The concept of adequate disclosure is one of fairness. Rigid rules cannot be formulated which are applicable in every conceivable case. Furthermore, adequacy must be measured as of the certification date. A fact assuming greater importance at a later date cannot be treated as having had such significance at the certification date.

Lybrand's objective was to set forth sufficient information to indicate the nature and value of the asset represented as the Valley Receivable. The conclusion Lybrand reached was that the asset was as good as the collateral. If the collateral was good, the receivable was "collectible" for their purposes.

Whether Valley could pay on September 30, 1962, or whether Roth had received the proceeds of the loans through Valley had little, if anything, to do with the asset's value. The adequacy of the collateral determined this. It is primarily the asset's represented value which must be challenged as affecting the fair presentation of financial position. Continental would have folded just the same had the receivable been labeled "Harold Roth" on the balance sheet. The asset did not appear to have any greater value absent this disclosure.⁴⁴

The disclosure of Valley's inability to pay and Roth's ultimate receipt of the money was a proper, if not necessary, subject of disclosure with respect to Continental's officers and directors.⁴⁵ But this could hardly be deemed required

43 See the Government version of an adequate "Note 2" to Continental's financial statements reproduced in the text following note 12 *supra*. As will be noted, the Government also maintained that the defendants had a duty to disclose that the Valley Payable could not be offset against the Valley Receivable. See note 10 *supra*. The presentation in the balance sheet proper indicated this, but Note 2 made reference to the "net receivable."

This was an extremely bitter issue throughout all the proceedings, but it will not be treated here for the reasons set out in note 10 *supra* and because the netting controversy has little relevance in the disclosure debate.

The concern here is with determining what disclosure was required to satisfy the third reporting standard. This was admittedly a pertinent bit of information and it is conceded that its disclosure was necessary to a fair presentation. The real controversy, however, involved determining whether the netting in Note 2 was an error or a deliberate attempt to mislead. The problem was one of establishing the defendants' intent in the case.

44 STATEMENT 33 at 55 provides that "Disclosure should not be considered to require publicizing certain kinds of information that would be detrimental to the company or its stockholders."

45 The auditor has an implicit obligation to apprise management of information acquired during the audit that should be in its possession whether it be merely a helpful suggestion

under the disclosure standard. Such disclosure could likely be improper or misleading in itself.

The necessity or propriety of disclosing post-balance sheet developments is governed by a particular set of rules.⁴⁶ Unless such a development has "a material effect on the financial statements,"⁴⁷ it probably should not be adjusted or annotated in the statements.⁴⁸ It is doubtful whether the Continental balance sheet created any material misapprehension that could have been avoided by disclosing that the receivable had increased in amount to \$3.9 million by the certification date. The information would have had little or no impact.

The adequacy of disclosure regarding the makeup of the collateral presents a much closer question. One of Lybrand's objectives in presenting Note 2⁴⁹ was to apprise the reader of the circumstances qualifying the representation of the Valley Receivable as a valuable asset.

Notes are an integral part of financial statements. Any information required to prevent financial statements from being misleading and any information that cannot be conveniently or adequately presented in the statements proper should be presented in a note. It is important that notes convey the exact information intended; they should be clear and concise. Notes should be used to present

relating to an observation made during the audit or a more serious matter demanding action by management. This is one of the ancillary services provided with all audits.

This obligation is *not* one to the public, however. Regardless, Lybrand did not fail in this duty, because all of Continental's directors, with one possible exception (one director was deceased at the time of the trial), knew of Roth's transactions:

The deceased director was Eric Johnston, whose name was not mentioned at the trial until the prosecutor asserted his "independence" in summation. The other directors clearly knew all there was to know about Valley. Not only were Continental's advances to Valley disclosed in the annual financial statements of Continental, but a registration statement which Continental filed in December, 1961 and which was signed by all of Continental's directors stated that Continental made advances to Valley from time to time as monies were available. The entire matter of Continental's loans to Valley and Valley's loans to Roth was reviewed at a special board meeting called on February 13, 1963, in response to Simon's requirement that the board approve the collateral arrangements. Schuster, an alleged co-conspirator and a director and the Treasurer of Continental, signed many of Continental's checks to Valley and borrowed from Valley when he needed funds; Sternberg, an alleged co-conspirator and an officer and director of Continental, also frequently borrowed funds from Valley, and as an officer of Valley, signed Valley checks payable to Roth; Meresman was a director of Continental and a partner of Abrams, Meresman & Co., Valley's auditors; Meresman's partner, Abrams, was a Continental director through 1960; Clifford, another alleged co-conspirator and a Continental director from 1958 through October, 1962, was a Vice President of the Franklin National Bank, the banker for Roth, Valley and Continental, with substantial loans outstanding to each, and regularly received financial statements of Valley and Roth, all of which reflected loans by Valley to Roth; Field, Roth's long-time friend and lawyer and an alleged co-conspirator, was Continental's general counsel, a one-quarter owner of Valley and a director of Continental until 1960 when his partner, Florea, succeeded him. The Continental board meeting of February 13, 1963 was held in Field's office. Field received Valley's financial statements and knew since 1957 that Roth borrowed from Valley. In addition, Forbes and Hirsch were each at various times directors of Continental and each had substantial investments in Valley. Hirsch was Continental's board chairman in 1960. Appellant's Brief in footnote at 65.

46 See STATEMENT 33 at 75-83.

47 *Id.* at 75.

48 "The independent auditor should consider subsequent events and require, as appropriate, adjustment of the accounts or disclosure of those matters *essential to proper interpretation of the financial statements being presented.*" (Emphasis added.) *Id.* at 76.

STATEMENT 33 goes on to describe the nature of those items that would require such disclosure.

49 See Note 2 reproduced in the text following note 9 *supra*.

necessary information or explanations; they should not be used to present information that may be interesting but not important.⁵⁰

The impression that "secured by the assignment to the Company of Valley's equity in certain marketable securities" conveys is not the one that should have been conveyed in this case. In the vernacular, "marketable securities" implies at least a modicum of stability with respect to value. It is usually preferable to disclose the nature of the collateral, *e.g.*, "500 shares of ABC Company common stock held as collateral (no quoted market)" or "mortgage on residential real estate held as collateral."⁵¹

Under the circumstances, the possibility of creating misconceptions sans disclosure of the makeup was too great. Financial position based upon the value of securities whose value was based upon financial position was the paper tiger of Note 2.

The argument against the position that such disclosure was required is that Lybrand's responsibility was to determine the sufficiency of the collateral.⁵² Disclosing the makeup of the collateral would not have done that. This does not, however, vindicate the misleading nature of Note 2.

C. Other Standards

Three additional generally accepted auditing standards at least deserve mention in the evaluation of Lybrand's performance.

One standard (referred to in the accounting profession as the Third General Standard) requires that "[d]ue professional care is to be exercised in the performance of the examination and the preparation of the report."⁵³ This standard demands a critical review *at every level* not only of the work done but also the judgment exercised. The information available does not indicate that the decisions of Simon and Kaiser were reviewed at any length (or at all) by other Lybrand partners.⁵⁴ Perhaps this would have been going a step beyond the customary limit, but under the circumstances judgment as to the adequacy of the security and the quality of the statement presentation was left unreviewed.⁵⁵ It can be argued that such an unusual procedure would have been warranted here.

50 See note 13 *supra*.

51 *Id.*

52 See text accompanying notes 27-40 *supra*.

53 STATEMENT 33 at 15.

54 In his opinion, Judge Friendly makes reference to "[t]he apparent failure of the defendants to consult with the Lybrand executive committee, or with the partner in the firm to whom 'problems' in audits were supposed to be referred, on what would seem highly important policy questions." 425 F. 2d at 809.

One of the factors precipitating Continental's collapse was Lybrand's withdrawal of its certification of Continental's statements. Obviously, someone in the Lybrand organization reviewed the defendants' judgment and found it wanting. *This* review came too late to do any good.

55 In the ordinary situation, staff level accountants do virtually all of the actual audit work on an engagement, and their work product is reviewed in detail a number of times at each level prior to certification. It is this review, during which mature judgment challenges the validity of the rationale employed to infer the veracity of a particular statement fact from the interaction of various audit evidence, that is the "essence of the audit." This stringing together of syllogisms and scrutiny from many different angles decisively tests the basis upon which the opinion rests.

Due care is essentially the reasonable care and diligence expected from a professional.⁵⁶ Did the defendants proceed with such care? Probably not.

A second standard (referred to in the accounting profession as the Second Standard of Reporting) requires that "[t]he report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting."⁵⁷ A far-fetched argument must be contrived to challenge Lybrand's compliance with this standard. Generally accepted accounting principles are, for the most part, rules based upon theories of classification.⁵⁸ This is of course an over-simplification. It nevertheless must be realized that generally accepted accounting principles primarily concern themselves with such problems as determining what an asset is, how long it remains an asset, and at what point in time it becomes something else. If the Valley Receivable was, in fact, an asset, it was properly classified and described in the Continental balance sheet.⁵⁹ Whether it was an asset is purely an abstract question, not at all appropriately raised in the present context.⁶⁰

Finally, a third standard (referred to in the accounting profession as the Fourth Standard of Reporting) requires the accountant to express an opinion on the fairness of presentation of the financial statements taken as a whole or to disclaim the same setting forth the reasons therefor.⁶¹ Any opinion expressed must be subject to an examination conducted in accordance with generally accepted auditing standards. Lybrand's unqualified opinion warranted this compliance as well as conformity with generally accepted accounting principles, adequate disclosure, and consistency of presentation (except as noted). As has

56 *Maryland Casualty Co. v. Cook*, 35 F. Supp. 160 (E.D. Mich. 1940); *L.B. Laboratories v. Mitchell*, 39 Cal.2d 56, 244 P.2d 385 (1952); *Dantzer Lumber & Export Co. v. Columbia Casualty Co.*, 115 Fla. 541, 156 So. 116 (1934); *Board of Comm'rs v. Baker*, 152 Kan. 164, 102 P.2d 1006 (1940); *Fidelity & Deposit Co. v. Atherton*, 47 N.M. 443, 144 P.2d 157 (1943); *Gammel v. Ernst & Ernst*, 245 Minn. 249, 79 N.W.2d 364 (1955); *East Grand Forks v. Steele*, 121 Minn. 296, 141 N.W. 181 (1913); *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931); *Smith v. London Assur. Corp.*, 109 App. Div. 882, 96 N.Y.S. 820 (1905); *O'Neil v. Atlas Automobile Finance Corp.*, 139 Pa. Super. 346, 11 A.2d 782 (1940).

57 STATEMENT 33 at 16.

58 See a more sophisticated view in GRADY, ACCOUNTING RESEARCH STUDY No. 7, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES at 47-68 (1965).

59 See AICPA, ACCOUNTING RESEARCH BULLETIN No. 43, RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS at 19-23 (1953); AICPA, APB ACCOUNTING PRINCIPLES, CURRENT TEXT §§ 2031.01-.06 and § 5111.01 (1968); GRADY, ACCOUNTING RESEARCH STUDY No. 7, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES at 226-28, 232-38, 240-41 (1965).

60 Here is where the mentioned argument can be contrived. The term asset implies value. See AICPA, ACCOUNTING TERMINOLOGY BULLETIN No. 1, REVIEW AND RESUME at 7-8, 12-13, 16-17 (1953); AICPA, ACCOUNTING TERMINOLOGY BULLETIN No. 3, BOOK VALUE at 37-38 (1956); GRADY, ACCOUNTING RESEARCH STUDY No. 7, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES at 229-30, 404, 412-13, 431 (1965). If the receivable had no value, it was not an asset and should not have been described as such.

This type of analysis is not contemplated by the first reporting standard. The real concern is with the "genesis" of accounting classifications, and the nature and treatment of items falling within a particular class in general. For our purposes, the Valley receivable could be nothing but an asset. This might seem rather elementary to the accountant, and not even worthy of mention. But see a similar analysis, seriously propounded, in one writer's criticism of the court's reasoning in *Teich v. Arthur Andersen & Co.*, 40 Misc. 2d 519, 243 N.Y.S.2d 368 (1963), *rev'd per curiam*, 24 App. Div.2d 749, 263 N.Y.S.2d 932 (1965) in Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437, 1456-58 (1967).

61 See STATEMENT 33 at 56.

already been suggested, perhaps Lybrand did not have sufficient evidence to support the opinion, nor was disclosure adequate to make the presentation fair. If this was the case, the warranties were breached.

IV. The Elements of the Crime

A. The Statutes

With this background, one may now focus upon the indictment and the related convictions.

There is no need to discuss the mail fraud counts because of their dependence on the conspiracy count.⁶² The mail fraud statute makes unlawful the use of the mails in the aid of a scheme or artifice to defraud.⁶³ The Continental statements were mailed. If the defendants, therefore, by their certification of those statements, took part in a criminal conspiracy, there is no doubt that they violated this statute.

Several ingredients were needed, however, to obtain the convictions on the vital count—the conspiracy charge. Initially, there had to be a conspiracy,⁶⁴ the object of which was to violate the cited statutes.⁶⁵ Each of the statutes, in turn, required certain elements to establish criminality. These elements necessarily had to be within the purview of the conspiracy.

To be liable under the fraud statute, a defendant must *knowingly and willfully*:

- 1) falsify, conceal or cover up a material fact;
- 2) make a false, fictitious or fraudulent statement or representation; or
- 3) make or use any false writing or document knowing the same to contain a false, fictitious or fraudulent statement or entry.

The SEC provision also specifies that the defendant must act knowingly and willfully. Here the proscribed act is making a statement in a required report that is false or misleading with respect to a material fact.

B. Conspiracy

Conspiracy, by its very nature, is difficult to prove. Normally, circumstantial

62 "To prove the crime of mail fraud, the Government had to establish that the defendants rendered an opinion on the Continental financial statements which they knew to be false or misleading and that they did so with specific intent to defraud. *United States v. Kyle*, 257 F.2d 559, 564 (2d Cir. 1958), *cert. denied*, 358 U.S. 937 (1959); *Williams v. United States*, 278 F.2d 535, 537 (9th Cir. 1960); *United States v. Corlin*, 44 F. Supp. 940, 943 (S.D. Cal. 1942)." Appellant's Brief at 66-67.

This burden is essentially the same one the Government had on the conspiracy count.

63 See 18 U.S.C. § 1341, reproduced in note 3 *supra*.

64 The conviction, technically, was under 18 U.S.C. § 371 (1964):

If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than \$10,000 or imprisoned not more than five years, or both.

If, however, the offense, the commission of which is the object of the conspiracy, is a misdemeanor only, the punishment shall not exceed the maximum punishment provided for such misdemeanor.

65 See the text of these statutes, reproduced in notes 2-4 *supra*.

evidence from which inferences of conspiracy can be drawn is introduced by the prosecution. The *sine qua non* of conspiracy is agreement.⁶⁶ The agreement need not be formal, but it must exist. The courts have held that agreement can be inherent in the acts of the co-conspirators and may be inferred therefrom.⁶⁷ Intent, generally of a criminal or corrupt nature,⁶⁸ as well as knowledge of the conspiracy⁶⁹ are also elements of the crime.

In the *Simon* trial, little evidence was introduced to substantiate the charge of conspiracy. Roth, an alleged co-conspirator, was the Government's main witness on this issue. Although he pleaded guilty on the corresponding conspiracy count against him,⁷⁰ his testimony made no reference to any agreement or understanding among himself and the defendants. Only his assertions that the defendants knew of his borrowings prior to February 6, 1963, gave the slightest basis for an inference of conspiracy.⁷¹ This conflicting testimony on an inconsequential question of fact⁷² supposedly implied the conspiratorial agreement.

When it is considered that many others (Field, Continental's directors,⁷³ and Roth's partners in Valley) knew of Roth's borrowings prior to February, 1963 (although Roth had lied to them as to the amount outstanding at September 30, 1962), it is difficult to believe that the defendants were involved in an exclusive conspiracy with Roth, the purpose of which was to conceal that Roth had received the money. It is likewise difficult to believe that Roth would have selected the defendants as partners in crime.

If there was such a conspiracy, the defendants certainly did not co-operate with Roth in any of his other attempts to improve the picture painted by Continental's statements. Irving Kalan, Continental's chief accountant, testified that

66 *American Tobacco Co. v. United States*, 328 U.S. 781 (1946).

67 *United States v. Johnson*, 165 F.2d 42 (3d Cir. 1947), *cert. denied*, 332 U.S. 852, *rehearing denied*, 333 U.S. 834 (1948); *Pietch v. United States*, 110 F.2d 817 (10th Cir. 1940), *cert. denied*, 310 U.S. 648 (1940); *United States v. Wilson*, 23 F.2d 112 (N.D. W.Va. 1927).

68 *Ingram v. United States*, 360 U.S. 672 (1959); *Direct Sales Co. v. United States*, 319 U.S. 703 (1943); *United States v. Chase*, 372 F.2d 453 (4th Cir. 1967); *Jefferson v. United States*, 340 F.2d 193 (9th Cir. 1965), *cert. denied*, 381 U.S. 928 (1965); *United States v. Standard Oil*, 316 F.2d 884 (7th Cir. 1963); *United States v. Zuideveld*, 316 F.2d 873 (7th Cir. 1963); *Danielson v. United States*, 321 F.2d 441 (9th Cir. 1963); *United States v. Ausmeier*, 152 F.2d 349 (2d Cir. 1945); *Blue v. United States*, 138 F.2d 351 (6th Cir. 1943), *cert. denied*, 322 U.S. 736 (1944); *Landon v. United States*, 299 Fed. 75 (6th Cir. 1924); *Farmer v. United States*, 223 Fed. 903 (2d Cir. 1915), *cert. denied*, 238 U.S. 638 (1915). See generally, Harno, *Intent in Criminal Conspiracy*, 89 U. PA. L. REV. 624 (1941).

69 *Direct Sales Co. v. United States*, 319 U.S. 703 (1943); *United States v. Falcone*, 311 U.S. 205 (1940); *Nassif v. United States*, 370 F.2d 147 (8th Cir. 1966); *United States v. Zuideveld*, 316 F.2d 873 (7th Cir. 1963); *United States v. Ah Kee Eng*, 241 F.2d 157 (2d Cir. 1957).

70 The appellant's brief points up some interesting sidelights about Roth's plea: "The unusual arrangements involved his pleading guilty to the conspiracy count—for which his testimony lent no support—for which he not only escaped trial on the substantive counts, but so far has escaped trial on a prior indictment of 105 counts of assorted crimes. . . ." Appellant's Brief at 67-68.

71 In substance, Roth testified that he had mentioned to Simon, upon first meeting him in 1960, that he had made a repayment to Valley a year earlier out of a loan which he had obtained from Loeb, Rhoades & Co. He also testified that he told Simon in December of 1962 that Valley could not pay its debt and that he offered to post collateral to secure the debt.

The counsel for Continental's trustee in bankruptcy, prosecuting a contemporaneous civil suit against Lybrand in connection with the Continental audit, along with his legal assistant and accountant, also testified that Simon had told them that he knew of or suspected Roth's borrowings prior to February 6, 1963.

72 See note 7 *supra*.

73 See note 45 *supra*.

prior to the closing conference of the Continental audit he submitted to the defendants a schedule of Continental's proposed adjusting entries, the \$904,000 effect of which would have been to show a profit of almost \$109,000 for fiscal 1962. Although these adjustments were compatible with generally accepted accounting principles, the defendants not only rejected them but also insisted upon adjustments resulting in the reported book loss of \$867,031 and the additional write-offs and write-downs in excess of \$3 million which ate up Continental's retained earnings and one-half its net worth.

The court of appeals' attempt to explain away this behavior which was directly at odds with the alleged conspiracy is weak:

The argument is impressive but not dispositive. Defendants may have harbored the illusion that the dexterity of Continental's treasurer in "juggling cash" would enable it to survive. Moreover, men who find themselves in a bad situation of their own making do not always act with full rationality.⁷⁴

This melodramatic portrayal of the panic malfunctioning of the criminal mind in the face of imminent apprehension is simply not appropriate in this case. Continental's survival was irrelevant and could have had no bearing on the defendants' decision to insist upon the bleaker of two income statement presentations. Furthermore, it is specious to denominate their decision an inadvertent departure from the conspiracy, the result of preoccupation with extricating themselves from the snare of their own sinister scheme. It is entirely more reasonable to admit that the weight of the evidence does not point toward the existence of the alleged conspiracy.

C. Criminal Intent

That the defendants acted knowingly and willfully is another finding subject to serious doubt. The concept of such specific intent is usually one involving moral turpitude. In cases where the defendant intended his actions, a demonstration of intent to commit a specific crime is not always necessary. Resort to this theory is usually limited to prosecutions for the more serious offenses, such as crimes of violence.⁷⁵ Although the term "willful" literally means deliberate or not accidental,⁷⁶ the Supreme Court has indicated that this generally encompasses a bad purpose, evil intent, or legal malice ("without justifiable cause, stubborn, obstinate or perverse").⁷⁷ In the case of statutory crimes, intent is often inherent in the act.⁷⁸ When intent is thus imputed,⁷⁹ moral turpitude becomes immaterial.⁸⁰

Before a meaningful inquiry can be made into the matter of the defendants' intent, one must consider the nature of the crimes allegedly pursued by the conspiracy. Though fraud is basically a civil cause of action, the substantive principles are the same in both civil and criminal cases. Fraud is either actual or

⁷⁴ 425 F. 2d at 809.

⁷⁵ *Ellis v. United States*, 206 U.S. 246 (1907).

⁷⁶ *United States v. Murdock*, 290 U.S. 389 (1933).

⁷⁷ *Id.*

⁷⁸ *Morrisette v. United States*, 342 U.S. 246 (1952).

⁷⁹ *Hargrove v. United States*, 67 F.2d 820 (5th Cir. 1933).

⁸⁰ *United States v. Balint*, 258 U.S. 250 (1922).

constructive. The most important feature of actual fraud is an actual intent to deceive.⁸¹ The fraudulent misrepresentation is aimed at a specific person or class. Constructive fraud, on the other hand, is characterized by an actual deception where no motive, specific intent or evil design might exist. It would seem absurd to postulate a conspiracy to commit constructive fraud.⁸²

The intent required in the instant case was the actual intent to deceive necessary to establish actual fraud.⁸³ Motive is by far the most prominent, credible and reliable symptom of such an intent.⁸⁴ The complete lack of motive is perhaps the most notable oddity in the case. There was certainly no financial incentive.⁸⁵

Although the Government introduced no evidence to support the contention, it suggested that the defendants were motivated by a desire to cover up Lybrand's negligent treatment of the receivable in prior years. This taxes the imagination. The indictment does not include counts relating to those prior years. Roth's borrowings, in any event, had been immaterial in prior years⁸⁶ and, for the most part, had been repaid. It is inconceivable that the threat to Lybrand's reputation could have been so serious as to drive reputable "men of blameless lives and respected members of a learned profession"⁸⁷ to the design of a criminal ploy. Judge Mansfield, who presided at the trial, also had difficulty with the Government's theory, noting that he had "a hard time seeing motive":

What I am talking about is, what is there that the accountant exposed himself to by not revealing that there had been indirect borrowings since repaid by the president of the company? I don't quite see how that would provide a motive for me to then go out and participate in some fraud for

81 The basic principles are so well established that most case law in the area is ancient. See *South Branch Lumber Co. v. Ott*, 142 U.S. 622 (1892); *Cooper v. Schlesinger*, 111 U.S. 148 (1884); *Neal v. Clark*, 95 U.S. 704 (1877); *Magee v. Manhattan Life Ins. Co.*, 92 U.S. 93 (1875); *Chanin v. Chevrolet Motor Co.*, 89 F.2d 889 (7th Cir. 1937); *Tooker v. Alston*, 159 Fed. 599 (8th Cir. 1907).

82 By definition, constructive fraud has no discernible object. The sanction, similar in nature to strict liability, is imposed *after the fact* in order to protect the interests of the injured party. Liability arises because the defendant's reckless conduct has effected a virtual fraud upon the deceived party.

Constructive fraud cannot exist *until* there has been an actual deception. If reckless conduct is *calculated* to cause the deception, there is intent and, therefore, actual fraud. Thus, a conspiracy can only have actual fraud as an object.

83 "[I]t is well settled that at least that degree of criminal intent necessary under the substantive offense must be proved to sustain a conviction of a conspiracy to commit that offense." (Footnote omitted.) *Danielson v. United States*, 321 F.2d 441, 445 (9th Cir. 1963).

84 One court said the following in regard to motive:

Fraud, civil or criminal, is almost always practiced for gain, wherein springs the motive. To make money or to get possession of money or its equivalent usually prompts those who practice fraud and those who scheme to defraud.

[I]ndeed strange would be a fraud where its promoter had neither a gainful incentive nor an intent to assist others in illegitimate efforts at enrichment. *United States v. Wise*, 108 F.2d 379, 381-82 (7th Cir. 1939).

85 According to Judge Friendly's opinion:

None of the defendants made or could make a penny from Continental's putting out false statements. Neither was there evidence of motive in the sense of fear that telling the truth would lose a valuable account. Continental was not the kind of client whose size would give it leverage to bully a great accounting firm, nor was it important to the defendants personally in the sense of their having brought in the business Ordinary commercial motivation is thus wholly absent. 425 F.2d at 808.

86 The only possible exception would be 1961. See text accompanying note 6 *supra*.

87 425 F.2d at 799.

fear it would be disclosed that I didn't report the indirect borrowings to [sic] Roth since washed out.⁸⁸

Even if this was the motive, does it not evidence merely a reckless attempt to hide a mistake rather than a conspiratorial purpose to defraud? Though it has been long established that proof of motive is not required for conviction,⁸⁹ it would seem that the Government was hard-pressed to show the *required species* of intent without it.

The holding, of course, indicated that the burden of establishing intent was maintained:

Even if there were no satisfactory showing of motive, we think the Government produced sufficient evidence of criminal intent. Its burden was not to show that defendants were wicked men with designs on anyone's purse, which they obviously were not, but rather that they had certified a statement knowing it to be false.⁹⁰

It does not seem too bold to suggest that this cut-and-dried approach alludes to the type of intent that is sufficient to establish *constructive fraud*, which is inapplicable in this case.⁹¹ What was alleged was a felonious *conspiracy*, allegedly authored by men bent on deception. The court of appeals recognized this principle at the outset:

Nothing turns on the different phrasings of the test of criminality in the three statutes. The Government concedes it had the burden of offering proof allowing a reasonable jury to be convinced beyond a reasonable doubt not merely that the financial statement was false or misleading in a material respect but that defendants knew it to be and *deliberately sought to mislead*.⁹² (Emphasis added.)

It would seem that the type of intent necessary to sustain the charges proffered was never established.

In the broad analysis, one discerns a series of "minimums" strung together, barely spanning the chasm of reasonable doubt. Except for the mailing of the Continental statements, there was no direct evidence available to prove violation of any of the involved statutes. There was no indication of the deception needed to establish either type of fraud, and the specific intent element of actual fraud was missing. The indictment could charge no more than conspiracy to defraud plus mailings in furtherance of that conspiracy.

Because there was no evidence of motive, the Government was forced to employ circumstantial evidence in its approach to the proof of intent. Each of the following circumstances supposedly gave rise to an inference of the defendants' intent:

1) The defendants' failure to disclose Roth's borrowings in the statements

⁸⁸ Reproduced in Appellant's Brief at 4.

⁸⁹ *Pointer v. United States*, 151 U.S. 396 (1894).

⁹⁰ 425 F. 2d at 809.

⁹¹ See note 82 *supra*.

⁹² 425 F.2d at 798.

although the prosecution established no duty imposed by professional standards as requiring such disclosure.⁹³

- 2) The alleged inadequacy of disclosure in Note 2 regarding the makeup of the collateral and the post-balance sheet rise in the receivable. Again, no duty was established.⁹⁴
- 3) The defendants' reference in Note 2 to the "net" receivable despite its proper description in the statement proper.⁹⁵
- 4) The defendants' alleged "purposeful" failure to discover certain prior liens on the collateral⁹⁶ notwithstanding the receipt of confirmations that did not disclose the liens.
- 5) The conflicting testimony as to when the defendants learned of Roth's borrowings even though they admitted knowledge of them prior to certification.⁹⁷
- 6) The defendants' failure to pursue the additional collateral⁹⁸ despite its ultimate recovery by Continental.

It must be remembered that the mission of these inferences was to establish beyond a reasonable doubt that the defendants conspired with Roth to conceal the fact that Roth had received the money. Even if the defendants had a duty to act upon discovering Roth's borrowings from Valley, it was never established that this duty was to disclose it in the financial statements. Yet the certification of the statements is the alleged fraudulent act. These inferences at best could only establish a constructive intent. The conspiracy itself could only be inferred. The intent shown under this "minimum" standard was inconsistent with the indictment.

Judge Bryan, presiding at the first trial, "observed that there was a 'close question' whether a reasonable juror could find guilt beyond a reasonable doubt."⁹⁹ Judge Mansfield indicated that the evidence was "extremely slim" and the case "barely submittable."¹⁰⁰ In addition, "In denying defense motions for acquittal or a new trial, Judge Mansfield said that 'the Court, had it been the trier of fact, would probably have found sufficient doubt to warrant acquittal.'"¹⁰¹ It can be contended that the jury, had it properly related the established intent to the alleged purpose of the conspiracy, could not have found guilt beyond a reasonable doubt.

93 Seven of eight expert witnesses who testified on the defendants' behalf indicated that such disclosure would have been inappropriate. See text accompanying notes 129-31 *infra*.

94 See text following note 113 *infra* for criticism of the Government's lack of regard for professional standards as defining the auditor's duties of disclosure. But see the rather harsh appraisal of the defendants' performance from an auditing standpoint in section III of the text *supra*.

95 See note 10 *supra*.

96 See note 9 *supra*.

97 See note 7 *supra*.

98 See note 10 *supra*.

99 Appellant's Brief at 13.

100 *Id.* at 3.

101 *Id.* at 14.

V. Conclusions

A. The Prosecution of the Case

Now that the Supreme Court has finalized the verdict by denying certiorari, one can ask what the decision means. Being the first case of its kind, it raises more questions than it answers. The first of these questions is why was the case prosecuted? Judge Mansfield expressed his misgivings as to the appropriateness of applying a criminal sanction in the circumstances:

The fraud charged here involved a highly technical and complex area, about which there is room for considerable difference of opinion, as to what balance sheet disclosure would have been appropriate.

The decision to prosecute this fraud criminally lay entirely within the province of the United States Attorney¹⁰²

These were not criminals. They were professional men who exercised extremely poor judgment. It was their misfortune that equally poor judgment made them the target of a pointless prosecution.

Jail sentences were not imposed. "The trial judge . . . remarked at the sentencing that 'I see no purpose whatsoever to be served by imposing jail sentences in this matter. . . . Nor do I see that jail sentences would serve any public interest either by way of setting an example or as a deterrent to others.'"¹⁰³ Judge Mansfield also observed:

These three defendants pose no risk to society. Their lives, as reflected in the probation reports, and as they unfolded from my own appraisal of them personally during the trial, and as testified to by the numerous letters of friends that the Court has received, have been exemplary. They are devoted parents; they are respected by their friends and their neighbors; they have worked hard in their lives to support themselves and their families; they are active adherents to their religious tenets, respectively.¹⁰⁴

Why, then, were the convictions pursued at all? This is not the ordinary case of "white-collar crime." The defendants did not utilize their position to a self-serving end. Unlike their co-conspirator, Roth, they had absolutely nothing to gain by their alleged crime. In essence, what they did was discover that Roth had been the ultimate beneficiary of the advances made to Valley in the course of determining the collectibility of that receivable. That determination of collectibility was their primary responsibility in undertaking to express an opinion on Continental's financial position. Their determination was, no doubt, in gross error. Considering the previous discussion regarding the defendants' performance, it seems that their most serious failing was in not disclosing the makeup of the collateral. The Government, however, would contend that each of their alleged derelictions had but one purpose: "'Everything' was designed, the prosecutor

¹⁰² *Id.*

¹⁰³ Brief for AICPA as Amicus Curiae at 35, *United States v. Simon*, 425 F.2d 796 (1969) [hereinafter cited as AICPA Brief].

¹⁰⁴ Appellant's Brief at 14-15.

said, 'to conceal that Roth got the money.'¹⁰⁵ The entire case was built upon this one malediction. Lost from sight was the question whether the defendants had a *duty* to disclose Roth's borrowings *in the balance sheet* and whether a breach of any such duty was *criminal* in nature. The court of appeals met this question as follows:

We join defendants' counsel in assuming that the mere fact that a company has made advances to an affiliate does not ordinarily impose a duty on an accountant to investigate what the affiliate has done with them or even to disclose that the affiliate has made a loan to a common officer if this has come to his attention. But it simply cannot be true that an accountant is under no duty to disclose what he knows when he has reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all the stockholders but for the private benefit of its president. For a court to say that all this is immaterial as a matter of law if only such loans are thought to be collectible would be to say that independent accountants have no responsibility to reveal known dishonesty by a high corporate officer. If certification does not at least imply that the corporation has not been looted by insiders so far as the accountants know, or, if it has been, that the diversion has been made good beyond peradventure (or adequately reserved against) and effective steps taken to prevent a recurrence, it would mean nothing, and the reliance placed on it by the public would be a snare and a delusion.¹⁰⁶

This analysis by the Second Circuit sounds highly persuasive, but does not realistically approach the problem. While Roth's borrowings might have been improper from Continental's standpoint, they certainly were not ostensibly illegal. Even if they had been, it does not follow that the defendants had a duty to disclose the matter *to the stockholders* in the balance sheet. Had the defendants made such a disclosure, they would have been usurping a function and responsibility of management.¹⁰⁷ It was Continental's other directors whose duty it was to decide what, if anything, should have been done about the situation. It was *they* who had a responsibility to the stockholders.

The defendants made no attempt to conceal Roth's borrowings from these men. Simon's insistence that Continental's directors approve Roth's transactions insured that the burden was placed squarely on the proper shoulders.¹⁰⁸ This evidences the defendants' respect for the limits of their jurisdiction, not a conspiracy to hide the true facts from everybody.

It does not seem manifestly unjust that Continental's other directors were not prosecuted. They had not taken the money. Yet the allegedly fraudulent financial statements were *their* representations.¹⁰⁹ They certainly had more reason to conceal these unsavory details from the stockholders who had entrusted *them* with Continental's assets. On the other hand, it could not make any difference to the defendants whether *anyone* knew. Their certificate purported only to vouch for the presented financial position. Their concern had to be whether their

105 *Id.* in footnote on page 2.

106 425 F.2d at 806.

107 See note 93 *supra*.

108 Although the board disapproved Roth's dealings at a special meeting on February 13, 1963, their action constituted an official admission that they knew all the pertinent facts.

109 See note 15 *supra*.

implicit representation as to the value of the receivable could be challenged. It cannot be asserted that their conduct was criminal while that of Continental's board was not.

One must distinguish between civil and criminal wrongs. The injury here was not to society but was to those who relied upon Lybrand's representation as to financial position. Those damaged in reliance upon this representation had a remedy.¹¹⁰ It was not the defendants' fault that the receivable was uncollectible, and their culpability in merely reporting on it was much too attenuated to have warranted the prosecution. Criminal responsibility for accountants should be limited, as it has been in the past,¹¹¹ to situations in which the accountant has willfully falsified statements or intentionally made "affirmative misrepresentations of figures . . . demonstrably false."¹¹² As Judge Mansfield pointed out:

[T]he "remedy" in "such a technical area where there was so much difference testified to between experts" does not lie in "jail sentences" but rather "lies elsewhere"—in SEC regulations "if the SEC believes that disclosures of the type indicated by its officials here should have been made" or in action by the American Institute of Certified Public Accountants to "revise auditing standards and accounting principles."¹¹³

B. The Standards of the Profession and the Role of Expert Testimony

Without conceding that a criminal proceeding was proper here, a criticism of the prosecution approach within the criminal context seems appropriate. In a case where the alleged malefaction was the failure of professional men to discharge their duties, proof of departure from established professional standards would seem indispensable to a showing of guilt. Yet the prosecutor objected at both trials "to the receipt of any expert testimony as to generally accepted accounting principles,"¹¹⁴ and tendered to the jury the proposition that "in 'measuring' the defendants' state of mind . . . 'probably the least important thing in the world is generally accepted accounting principles.'"¹¹⁵

To fully appreciate the role played by expert testimony in this case, one must first consider the stature of the witnesses called to testify in the defendants' behalf:

MARSHALL S. ARMSTRONG, head of the accounting firm of George S. Olive & Co. of Indianapolis, a large regional firm of 32 partners and 175 staff accountants. Mr. Armstrong was founding chairman of The American Group of CPA Firms, a federation of regional firms, a member of the Ac-

110 Lybrand settled the \$41 million suit filed against it in connection with the Continental audit for \$2.1 million. See Wall Street Journal, Oct. 18, 1966, Oct. 6, 1967, Oct. 17, 1967, Oct. 23, 1967, and New York Times, June 22, 1968.

111 See *United States v. Benjamin*, 328 F.2d 854 (2d Cir. 1964), cert. denied, 377 U.S. 953 (1964). See also *Brethauer v. United States*, 333 F.2d 302 (8th Cir. 1964); *Neely v. United States*, 300 F.2d 67 (9th Cir. 1962), cert. denied, 369 U.S. 864 (1962).

112 AICPA Brief at 16.

113 Appellant's Brief at 4-5.

114 *Id.* at 9-10.

115 *Id.* at 7.

counting Principles Board of the American Institute of Certified Public Accountants, a past member of the Institute's Committee on Auditing Procedure and of the Institute's Practice Review Committee, past president of the Indiana Association of Certified Public Accountants and Chairman of the Project Advisory Committee for Accounting Research Study on Corporate Stockholders' Equity.

CARMAN G. BLOUGH, the acknowledged dean of the accounting profession. Mr. Blough is a former partner of Arthur Andersen & Co., the first chief accountant of the SEC, former Director of Research for the American Institute of Certified Public Accountants and has taught and lectured extensively at a number of American universities. He was awarded the Institute's Distinguished Service Award in 1963 and has served on the Institute's Accounting Principles Board and Committee on Auditing Procedures. Mr. Blough has written extensively on accounting subjects.

ARTHUR P. BARTHOLOMEW, JR., a member of the managing committee of Ernst & Ernst and partner in charge of that firm's eastern offices.

JOSEPH P. CUMMINGS, partner in charge of professional practice at Peat, Marwick, Mitchell & Co. and a member of the Institute's Accounting Principles Board.

JOHN K. McCLARE of S. D. Leidesdorf & Co., a member of the Accounting Principles Board and a past member of the Committee on Auditing Procedure and the Practice Review Committee. Mr. McClare was formerly chief accountant of the SEC's Division of Corporate Finance.

ANTHONY PUSTORINO, a practicing accountant who teaches accounting at Pace College, one of the country's leading undergraduate schools of accounting.

ROBERT M. TRUEBLOOD, the professional head of Touche, Ross, Bailey & Smart and a past president of the Institute. Mr. Trueblood has written extensively on accounting subjects, has served on the Institute's Accounting Principles Board and has been the recipient of a number of awards for professional achievement.

FRANK L. WESTON, director of professional work at Arthur Young & Co. and a member of the Accounting Principles Board.¹¹⁶

Their testimony corroborated many of the conclusions reached above. They testified that professional standards did not require disclosure of Roth's borrowings—seven of them being of the opinion that such disclosure would have been improper. They also testified that the defendants were under no duty to disclose

the post-balance sheet increase in the receivable. The only significant difference among these eight witnesses is in regard to the alleged duty to disclose the makeup of the collateral. Though all agreed that there was no recognized duty to disclose the makeup of collateral within financial statements, three of the experts felt that disclosure in the circumstances would have been desirable. The Government made only a token effort to establish by expert testimony any departure from professional standards. Charles Pardee, an SEC staff accountant, the Government's sole expert witness on its direct case—a witness who "had never certified a financial statement or worked as a certified public accountant on an audit which had certification as its purpose"¹¹⁷—testified that "practice" required the defendants to have *audited Valley's books*. He was quite sure of himself, indicating, "I don't believe anyone will follow me here and say to the contrary."¹¹⁸ He said this after nine distinguished experts *had* said to the contrary in his presence at the first trial. As was pointed out in the appellant's brief:

He could cite nothing in published standards or principles, accounting literature or precedent in support of his views, and all he ventured as any source of authority for his views was the enigmatic statement that "in my conversations with partners of leading firms . . . I have formed in my own mind what I believe they think would be what they would have to do under similar circumstances."¹¹⁹

In rebuttal, the Government called Andrew Barr, Chief Accountant of the SEC. He was considerably more cautious than his subordinate. He ventured an opinion that better practice would have been to make the allegedly required disclosures, conceding "that he would expect other accountants of equal competence and unquestioned integrity to disagree with him."¹²⁰

There can be no question but that the evidence offered by the Government to prove the defendants' deviation from professional standards could not even begin to ply its task in the face of the defendants' proof. The court of appeals asked: "With due respect to the Government's accounting witnesses . . . we are bound to say that they hardly compared with defendants' witnesses in aggregate auditing experience or professional eminence."¹²¹

A thoughtful consideration of the foregoing yields a realization of the prosecutor's utter contempt for the established standards of the accounting profession. At one point he characterized them as "self-serving platitudes designed by the accounting profession to protect itself from civil liability."¹²² His case was built upon the assumption that the standards of the profession were immaterial to the determination of the defendants' guilt. This circuitous route to conviction, condoned by the court, was dangerous policy in that it served to undermine the foundations of an entire profession. The bitterly contested issue of jury instructions illustrates this. The defendants had asked for two instructions as follows:

117 *Id.* at 51.

118 *Id.* at 54.

119 *Id.* at 53.

120 *Id.* in footnote at 53.

121 425 F.2d at 805.

122 Appellant's Brief at 54.

41 Thus, a defendant may be found guilty only if you find beyond a reasonable doubt that the financial statements as a whole did not fairly present the financial condition of Continental at September 30, 1962, according to generally accepted accounting principles, that he knew that the financial statements as a whole did not fairly present the financial condition of Continental at September 30, 1962, according to generally accepted accounting principles, that he participated in the certification with this knowledge and with the intent to deceive and defraud.

44 If defendants' certification of the Continental financial statements was rendered in accordance with generally accepted accounting principles, they must be acquitted without regard to any opinion you might otherwise form as to proper standards. Only if the defendants failed to comply with the generally accepted standards of their profession can there be any question of wrongdoing on their part. If they did fail in material respects, then the question is whether their failure was due to inadvertence, mistake, negligence or a willful disregard of those standards with knowledge of falsity of the statements certified and with intent to deceive. Only in the last event may they be found guilty.¹²³

The instructions finally given similarly charged that "the 'critical test' was whether the financial statements as a whole 'fairly presented the financial position of Continental as of September 30, 1962. . . .'"¹²⁴ In the event they did not, an assessment of the defendants' good faith was to be the deciding factor in the determination of guilt: "Proof of compliance with generally accepted standards was 'evidence which may be very persuasive but not necessarily conclusive that he acted in good faith, and that the facts as certified were not materially false or misleading.'"¹²⁵

The court of appeals held that there was no error in charging the jury thus, minimizing the distinctions between the instructions requested and those given.¹²⁶ The differences were fundamental, however, because the charge, in relegating professional standards to a mere advisory capacity, thereby gave the jury franchise to determine for itself what duties of disclosure the defendants had. The jury's province should not have extended beyond a factual determination of whether the defendants had breached duties established as a matter of law.

The jury was sent into deliberation with the following charge:

A material fact is a fact to which an average, reasonably prudent person would attach importance in determining a course of conduct to be taken or followed upon learning the fact, such as in deciding whether or not to buy or sell stock, or to lend or refuse to lend money, or to cancel a loan.¹²⁷

The accountant does not purport to warrant that all such facts are disclosed in the statements. Many of these have no place in financial statements. How can he be expected to guess what a juror will later find to be important among a

123 *Id.* at 44.

124 425 F.2d at 805.

125 *Id.* at 805-06.

126 *See id.* at 806.

127 Appellant's Brief at 46.

myriad of facts? Of what importance can generally accepted accounting principles and generally accepted auditing standards be if additional, possibly conflicting principles and standards may be imposed at any time by a jury that might not fully comprehend the auditor's task? Such instructions create an intolerable situation for the accountant on the job.

The Government did not seek to establish the defendants' violation of professional standards, though it certainly could have.¹²⁸ As a result, the value of expert testimony was all but lost and the accounting profession was left with no reliable basis upon which to support opinions on financial statements.

C. The Use of a Jury

Another serious problem with the approach to the conviction involves the Government's insistence upon a jury trial. Federal Rule of Criminal Procedure 23(c) requires the consent of the court and the Government before a defendant may be allowed to waive a jury trial. The Supreme Court in *Singer v. United States*¹²⁹ has upheld the right of the Government to withhold its consent without giving its reasons.¹³⁰

The rationale of allowing waiver is simple enough. The jury has traditionally been considered a valuable right of the defendant, a right affording him a measure of protection. It is a privilege, not an inherent component of our judicial structure.¹³¹ Where, as here, the use of a jury prejudices the efforts of the defendant to make his case understood, he ought to have the opportunity to select a more suitable finder of fact, one who will set out "with reasoned analysis the grounds of decision, so that an appellate court can determine whether the decision is supportable."¹³² It has been held, however, that merely because the subject matter of the alleged offense is complex does not mean the defendant has a right to a non-jury trial over the objection of the prosecutor.¹³³

*Escott v. Barchris Construction Corp.*¹³⁴ provides an example of the vastly superior proceeding facilitated by a non-jury trial in a complex case involving professional standards. A case that shook the accounting world, *Barchris* involved the imposition of civil liability on the defendant accountants, Peat, Marwick, Mitchell & Co., for their failure to exercise due diligence as required of experts under § 11b of the Securities Act of 1933,¹³⁵ in connection with their signing of a

128 See section III of the text *supra*.

129 380 U.S. 24 (1965).

130 *Id.* at 37. See also *United States v. Holt*, 333 F.2d 455 (2d Cir. 1964); *United States v. Igoe*, 331 F.2d 766 (7th Cir. 1964); *Dixon v. United States*, 292 F.2d 768 (D.C. Cir. 1961); *Mason v. United States*, 250 F.2d 704 (10th Cir. 1957).

131 *Patton v. United States*, 281 U.S. 276 (1930).

132 Appellant's Brief at 59.

133 *United States v. Abrams*, 357 F.2d 539, 549 (2d Cir. 1966), *cert. denied*, 384 U.S. 1001 (1966).

134 283 F. Supp. 643 (S.D.N.Y. 1968).

135 The statute reads, in pertinent part, that:

Notwithstanding the provisions of subsection (a) no person . . . shall be liable as provided therein who shall sustain the burden of proof—

(3) that . . . (B) as regards any part of the registration statement purporting to be made upon his authority as an expert . . . (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the

Barchris registration statement. Judge McLean, contending with a 6,500-page record, heavily laden with disconnected, technical testimony, demonstrated in his 65-page opinion that he was eminently qualified to handle such a case. His methodical and objective approach afforded the defendants every reasonable opportunity to make certain the relevant issues would be determinative. He was careful to delimit liability in accordance with the degree of responsibility assumed by the defendants, recognizing that they were not amenable to challenge on figures appearing in unaudited interim statements submitted with the registration statement but not covered by their report, although the stricter standard was applied to the audited statements.¹³⁶ He also acknowledged that the accountant's duties do not extend beyond the proper scope of the financial statements upon which he reports:

The cross reference in footnote 9 to the "Methods of Operation" passage in the prospectus was inserted merely for the convenience of the reader. It is not a fair construction to say that it thereby imported into the balance sheet everything in that portion of the text, much of which had nothing to do with the figures in the balance sheet.¹³⁷

The judge's appraisal of the defendant's performance demonstrated a remarkable understanding of auditing techniques and the nature of the inferences which may validly be drawn from the results thereof. He turned to Statement on Auditing Procedure No. 33 in assessing the defendant's audit program¹³⁸ and recognized generally accepted auditing standards as controlling the defendant's conduct even with the limited examination. His finding of negligence rested firmly on the evidence having shown a departure from professional standards: "[T]here were enough danger signals in the materials which he did examine to require some further investigation on his part. Generally accepted accounting [*sic*] standards require such further investigation under these circumstances."¹³⁹

Many in the accounting profession cannot agree with Judge McLean's concept of "materiality" as expressed in some of his findings in the case, but this criticism does not go to the heart of the proceeding. Those not sharing the judge's opinion as to the materiality of certain items would not hesitate to agree that the determination of materiality *was* the dispositive issue.

The *Barchris* decision is at least palatable in that the defendant accountants were tried in the proper forum and against the proper standards: "Accountants should not be held to a standard higher than that recognized in their profession. I do not do so here."¹⁴⁰

In the *Simon* case, the Government refused to cite any reason for its insistence upon a jury trial:

registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements herein not misleading. 15 U.S.C. § 77k(b) (1964).

136 283 F. Supp. at 683-84.

137 *Id.* at 684.

138 He found the audit program to have been adequate but faulted the defendants with a failure to follow it faithfully. Some of the prescribed audit procedures only received token attention.

139 283 F. Supp. at 703.

140 *Id.*

It is indeed so unusual for the Government to insist upon a jury trial of a complicated case that insistence becomes suspect. . . . It might be . . . that the prosecutor did not like the judge assigned to the case. But such a reason hardly applies to two judges assigned by the Chief Judge by reason of the complexity and difficulty of the case.¹⁴¹

The interests of justice require that a prosecution demand for a jury trial be rooted in a desire to have the evidence fairly weighed rather than misunderstood. It would seem that the Government's adamant stand evidenced only a calculation of the easiest route to victory.

D. New Burdens on the Profession

Despite the harsh criticism that can be leveled at the distasteful verdict and the tactics employed in obtaining it, the decision stands, and the accounting profession must now face the realities of living with it and the new burdens which it has created. The case's greatest precedential significance lies in its setting new standards to measure accountants' criminality. Affirmative, purposeful misrepresentation is no longer the essence of an accountant's criminal conduct. Passive non-disclosure, even of information not necessarily covered by his report, will suffice. The accountant's representations do not have to participate in or cooperate with efforts to divert funds in order to render them felonious. Negligence and poor judgment have been recognized as sufficient indicia of criminal intent to impute criminality to conduct one step removed from any active wrongdoing.

With the decision, the profession has been put on notice that facts material to a fair presentation of financial position and results of operations are not necessarily limited to those prescribed by generally accepted accounting principles and generally accepted auditing standards. A jury now has the prerogative to deem material facts the inclusion of which might not even be appropriate in financial statements. In addition, professional judgment will sometimes be superseded by the accompanying judicially imposed requirements of disclosure. Thus, in the *Simon* case, disclosure of the makeup of the collateral and the post-balance sheet increase were not discretionary matters. Finally, the decision recognizes a duty of the accountant to serve in a capacity like that of a trustee. If he fails to disclose activities of management, discovered during the audit, that might not be consistent with its office, a sort of vicarious liability will be imposed. The consequences of such activity, including criminal sanction, will fall upon the non-disclosing accountant.

E. Meeting These Burdens

The decision is not wholly irreconcilable with the profession's concept of the accountant's responsibility. Strict compliance by the defendants in this case with the generally accepted auditing standards requiring sufficient competent evidential matter, adequate disclosure and due care, would have destroyed any possibility of establishing their criminal intent. What can the accountant do on

141 Appellant's Brief at 119.

the job to avoid a mishap like that befalling the Lybrand defendants? Basically, he can further intensify his efforts to know and live generally accepted auditing standards.

Though it is never discussed openly, there is a frame of mind almost universally prevalent among auditors, an attitude which, if present, might have been the single most contributing factor in the Lybrand defendants' downfall. Auditors do not like to be "bad guys." They do not look for trouble. They operate under the assumption that the client's representations are essentially accurate. This attitude is not, however, without merit. An auditor cannot verify everything. He must build a degree of tolerance that will enable him to discriminate between minor, relatively unimportant imperfections and serious deficiencies requiring remedial action. Thus, when audit evidence contradicting a desired conclusion (e.g., that internal controls are functioning properly or that an account balance represents all transactions of a given type) is uncovered, the auditor's first impulse usually leads to an attempt at reconciling the evidence to the conclusion.

The trouble comes when this attitude is nurtured past the point of its usefulness. The auditor must be extremely careful and guard against being convinced too easily that everything is all right. He must be aware that he generally has an underlying desire to be so convinced. The defendants in *Simon* were far too anxious to be satisfied that the Valley Receivable was a valuable asset, adequately secured. As a result, they grasped at straws incapable of overcoming the presumptive realities of the situation.

The auditor normally associates the concept of independence,¹⁴² or lack of it, with, at most, three situations:

- 1) where the auditor has some financial interest in the client;
- 2) where he has some personal interest (as when he is an officer or director); or
- 3) where the size of the client and its fee exert a degree of pressure on him.

The auditor must be psychologically, as well as financially, independent, however, to adequately perform his task. Independence, being a mental attitude,¹⁴³ need only slip from the auditor's grasp for a crucial instant to precipitate grave errors in judgment and the attendant consequences. Independence is an awareness that must be carefully maintained at all times by the auditor to insure that his conclusions will be tenable in light of the available evidence if they are subsequently challenged.

¹⁴² The Second General Standard of generally accepted auditing standards provides: "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." STATEMENT 33 at 15. See also AICPA, CODE OF PROFESSIONAL ETHICS, Article 1, § 1.01 (1967); AICPA, COMMITTEE ON PROFESSIONAL ETHICS, OPINION No. 12: INDEPENDENCE; SEC Reg. S-X, Rules 2-01(b) and (c), 17 C.F.R. §§ 210.2-01(b) and (c) (1969).

¹⁴³ In AICPA, COMMITTEE ON PROFESSIONAL ETHICS, OPINION No. 12: INDEPENDENCE, the following is stated: "In 1947 the Council of the American Institute said in an official statement on independence: 'Independence is an attitude of mind much deeper than the surface display of visible standards.'"

Auditors must faithfully follow the mandates of their manuals, programs, and texts. Those at higher levels should not be too quick to dismiss the doubts of a staff-level man. Materiality should receive the benefit of the doubt over immateriality. Most of all, the auditor should realize that management will not stick up for him in court if and when the company fails or some other major catastrophe strikes. When the auditor is convinced that management's presentation is not a truly acceptable one, he must not back down no matter how difficult this may be. In a word, auditors must be careful.

F. Recommendations

As a profession, accountants can work in three areas to mitigate the undesirable effects of the *Simon* decision.

First and foremost, the profession must make a concerted effort to communicate more effectively with the legal community. Maintaining the present excellent lines of communication with the SEC is not enough. Whether accountants realize it or not, the profession is under attack and must begin to defend itself. As Walter J. Coakley, a prominent attorney of the Wall Street firm of Sullivan & Cromwell, recently said:

A number of textbook writers and commentators on accountants' liability have suggested that there is a "trend" in judicial thinking which may result in imposing liability to third parties where the degree of the accountant's negligence is far less than that required by the *Ultramares* rule. The views these writers express often reflect a lack of understanding of the manner in which accountants work and of the way an audit is conducted. Many of these writers wholly fail to recognize that auditing is a process of selective review of the work of others, subject to the limitations inherent in such a process. This is not surprising, however, since many of these writers are law school students, candidates for graduate degrees or young professors who have had no practical experience with business or accounting. But their view is now referred to as the "progressive" view, and you know how reluctant people are these days—including judges—to reject any theory, whatever its merits, once it has been characterized as "progressive." Hope on the part of plaintiffs that courts will be influenced by this academic writing is one of the primary factors promoting the recent spurt in claims against auditors. This is clear from the briefs filed.¹⁴⁴

For example, one writer recently evidenced his apparent advocacy of a strict liability approach with respect to accountants' negligence in the *Columbia Law Review*.¹⁴⁵ He was obviously overcome with his proposition that "there has been no . . . effective check on accountants who mislead the public."¹⁴⁶ While advocating the demise of the *Ultramares* rule,¹⁴⁷ he indicated that "[F]ederal law is a more promising source of an adequate investors' remedy"¹⁴⁸ The writer then

144 126 J. ACCOUNTANCY at 59.

145 Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437 (1967).

146 *Id.*

147 See note 5 *supra*.

148 Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437, 1444 (1967).

very thoroughly analyzed the "obstacles" that must be overcome in order to predicate liability on the federal securities laws. He reflected optimism, pointing to the Second Circuit's abandonment of the strict construction of the phrase "in connection with the purchase or sale of any security" in finding accountants liable under SEC rule 10b-5 (promulgated under section 10(b) of the Securities Exchange Act of 1934) but seemed dismayed that it is presently difficult to find accountants liable as an aider and abettor relating to violations of rule 10b-5. He felt that a third-party plaintiff is unjustly "hindered" in recovering against an accountant since he "must still show that he relied on a fraudulent statement, and that his reliance was reasonable—or that the fraud was the direct cause of his harm."¹⁴⁹ He criticized cases that demonstrated "a somewhat less sophisticated concern with such details as the certification date and the logical implications of language in a certificate."¹⁵⁰

One cannot be quite sure what this writer advocates. It seems that he would give everybody in the world a cause of action when it can be shown that an accountant has been negligent without regard to what actually caused each individual plaintiff's injury. He obviously has no idea of what happens on an actual audit or the limits of what an auditor can do. Although all writers are not as unreasonable and unrealistic in their demands for an extension of accountants' liability,¹⁵¹ it must be realized that nobody feels sorry for the big, rich accounting firms.

Mr. Coakley further pointed out, however:

A number of members of the profession have, on the other hand, attempted in speeches and articles to counteract this influence. An article in the *Business Lawyer* last summer by Walter Hanson of Peat, Marwick contains a lengthy discussion of the nature of the accountants' function to the business public, and points out the misapprehension of the accountants' function by even their clients. I am sure that you have all read John Carey's excellent article early this year in the *Financial Analysts Journal* pointing out the lack of general understanding of the extent to which judgment enters into many of the seemingly factual items in financial statements. These articles are good examples of what the profession can do generally by way of educating the public and counteracting some of the unfortunate misunderstandings that appear to have occurred.¹⁵²

This is but a humble beginning, however. One can rest assured that judges are reading the *Columbia Law Review* more than the *Journal of Accountancy*, the *Business Lawyer* or the *Financial Analysts Journal*.

The accounting profession must make known to the legal profession the necessity of understanding the representations in the accountant's report and the reasons why generally accepted accounting principles and generally accepted auditing standards can be the only fair criteria to be used in judging an accountant's performance. The profession must heartily endorse the judicial recognition

149 *Id.* at 1451.

150 *Id.* at 1455.

151 See, e.g., Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139 (1968).

152 126 J. ACCOUNTANCY at 59.

of this criteria in the *Barchris* case and push for the adoption of Judge McLean's approach in all cases involving accountants' liability—civil or criminal.

Internally, the profession is already working in two areas in the hope of diminishing the threat of litigation. A lack of uniformity in generally accepted accounting principles has left the profession open to scathing, and probably deserved, criticism,¹⁵³ not to mention litigation. Many of the currently pending cases could not have been brought had there been only one acceptable financial statement presentation available to the respective defendants. The profession must continue to make efforts to eliminate unwarranted alternative generally accepted accounting principles. There is also a movement in the Institute's Committee on Auditing Procedure to propose a change in the wording of the standard short-form accountant's report. Walter J. Coakley has commented on this:

There has been a good deal of discussion about accountants' protecting themselves against liability by changing the wording of their report. I personally do not think that there is much chance that any substantial change would be acceptable to the business community. Of course, if you have real questions as to whether financial statements fairly present the financial position of a given business in any given respect, you should make appropriate exceptions in your report, or consider whether you can render a report at all.

.....
There has been a tendency in the profession, at times encouraged by administrative and regulatory authorities, to make financial statements more readable by simplification and elimination of language. The objective is certainly to be commended; but there are many times when precision is far more important than simplicity or brevity. When there is any doubt whether an explanation is needed or whether additional information would be helpful to the reader, the explanation should be given or the information supplied. Otherwise, the price of readability may become liability as a result of the omission.¹⁵⁴

While one may agree with Mr. Coakley, until such time as the profession can more solidly establish that the accountant's significant representations are to be found in the report, the actual wording of the report, with the exception of departures from the standard language, will receive little attention in court.

It is this feeling that prompts a proposal that might seem radical at first blush. It seems that whenever unqualified opinions accompany financial statements the courts literally hold the accountants responsible for all of the information contained therein. As long as the courts are going to take this approach, why not adopt the statements as the *accountant's* representations? In abandoning the staunch contention that the statements are the representations of *management*, accountants can acquire more leverage to insist upon the statement presentation they consider most fair in the sense that their liability (which is there anyway) gives them a stake in the matter. Furthermore, a conscious acknowledgement of this presently existing responsibility will aid the auditor in crystallizing his objec-

153 See Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139 (1968). See also ARTHUR ANDERSEN & Co., *ESTABLISHING ACCOUNTING PRINCIPLES—A CRISIS IN DECISION MAKING* (1965); SPACEK, *CORPORATE PROFITS: ACCOUNTING VARIATIONS AND THEIR EFFECT ON CORPORATE PROFITS* (1965).

154 126 J. ACCOUNTANCY at 60.

tives and maintaining the psychological independence discussed above while dispelling any false sense of security that might be present.

Finally, in the area of legislation, the profession might consider two possibilities. Arthur Andersen & Co. has long been the proponent of creating a United States Court of Accounting Appeals to aid in the establishment of standardized accounting rules and practices.¹⁵⁵ Their proposal is worthy of consideration. Having considered the iniquities that can result with the use of a jury in a case like *Simon* it is also recommended that the profession seek a legislative amendment to Federal Rule of Criminal Procedure 23(c) which would in effect allow a defendant in a criminal proceeding to waive a jury trial in the absence of the Government's consent upon a failure of the Government to show good cause for its objection to a non-jury trial.

*Fred Kuhar**

155 See ARTHUR ANDERSEN & CO., ESTABLISHING ACCOUNTING PRINCIPLES—A CRISIS IN DECISION MAKING 31 (1965) (draft of a proposed bill establishing such a court).

* Mr. Kuhar has passed the Ohio Certified Public Accountant exam and has worked as an auditor for one of the leading international public accounting firms. He is currently completing his experience requirement for his CPA certificate. He will graduate from Notre Dame Law School in May, 1971.